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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-309

TOUCHE ROSS & Co.,

Petitioner,

against

EDWARD S. REDINGTON, as Trustee for the liquidation of WEIS SECURITIES, INC. and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF RESPONDENT REDINGTON

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TABLE OF CONTENTS

	PAGE
Table Of Authorities	ii-vii
Preliminary Statement	1
Additional Statutes Involved	2
Counter-Statement Of The Questions Presented	2
Counter-Statement Of The Case	3
Background Of The Litigation	4
Requirements Of Section 17 And Rule 17a-5	5
Non-Disclosure Of Fraud In The Documents Certified By Touche Ross	8
The Weis Liquidation And The Filing Of The Federal Action	10
The Federal Action	11
The State Court Action	12
The Opinions Below	15
Summary of Argument	17
Argument	25
I. A Private Right of Action Under Sections 17 and 27 of The Exchange Act is Necessary to Protect Customers for Losses That Cannot be Prevented When an Accountant Does not Comply With Rule 17a-5	25
A. Accountants Performing Rule 17a-5 Audits Assume Important Duties For The Benefit Of Customers Which Are Enforceable In "Actions At Law" Under Section 27	25

PAGE

B. Customers Are An "Especial Class" Protected By Rule 17a-5 28

C. A Right Of Action On Behalf Of Customers Is Essential To Achieve Section 17's Goals Of Protecting Customers 30

D. The Decisions Under Section 6 Of The Exchange Act, As Well As This Court's Decision In *Borak*, Support A Right Of Action Under Section 17 35

II. THERE ARE NO PERSUASIVE ARGUMENTS AGAINST RECOGNIZING A PRIVATE RIGHT OF ACTION UNDER SECTION 17 39

A. Section 18 Is Not Pertinent To Section 17 39

B. The Miscellaneous Policy Considerations Adverted To By Touche Ross Are Of No Moment 47

C. Scienter Is Not Required To Sustain A Right Of Action Under Section 17 51

III. The TRUSTEE IS A REAL PARTY IN INTEREST TO SUE UNDER SECTION 17 FOR DAMAGES TO THE FUND OF CUSTOMER PROPERTY OF WHICH HE IS BAILEE 52

Conclusion 61

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Aldrich v. *Redington, (In re Weis Securities, Inc.)* [1977-78 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 66,884 (2d Cir. 1978), *cert. denied sub nom., Grossmann* v. *Redington*, No. 78-746 (Jan. 22, 1979) 30

Allen v. *State Board of Elections*, 393 U.S. 544 (1969) 33

Aluma Kraft Manufacturing Co. v. *Elmer Fox & Co.*, 493 S.W. 2d 378 (Mo. Ct. App. 1973) 32n

PAGE

Arizona Title Insurance and Trust Co. v. *O'Malley Lumber Co.*, 14 Ariz. App. 486, 484 P.2d 639 (1971) 31n

Arneil v. *Ramsey*, 550 F.2d 774 (2d Cir. 1977) 35

Baird v. *Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944) 18, 35-36, 38, 42, 47

Baldwin v. *Hill*, 315 F.2d 738 (6th Cir. 1963) 57

Bell v. *Hood*, 327 U.S. 678 (1946) 26

Berger v. *34th Street Garage, Inc.*, 274 App. Div. 414, 84 N.Y.S.2d 348 (1st Dep't 1948), *appeal denied*, 275 App. Div. 660, 86 N.Y.S.2d 667 (1st Dep't 1949) 56n

Biakanja v. *Irving*, 49 Cal. 2d 647, 320 P.2d 16 (1958) 32n

Bivens v. *Six Unknown Named Agents of Federal Bureau of Narcotics*, 403 U.S. 388 (1971) 27, 33

Blue Chip Stamps v. *Manor Drug Stores*, 421 U.S. 723 (1975) 21, 22, 23, 38n, 45-47

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Bradley v. *St. Louis Terminal Warehouse Co.*, 189 F.2d 818 (8th Cir. 1951) 56, 57

Butterman v. *Walston & Co.*, 387 F.2d 822 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968) 35

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Content v. *Banner*, 184 N.Y. 121, 76 N.E. 913 (1906).... 53n

Cort v. *Ash*, 422 U.S. 66 (1975) 20, 30, 33, 39, 51

Craig v. *Everett M. Brooks Co.*, 351 Mass. 497, 222 N.E.2d 752 (1967) 32n

Deckert v. *Independence Shares Corp.*, 311 U.S. 282 (1940) 26

Ernst & Ernst v. *Hochfelder*, 425 U.S. 185 (1976) ..24, 27, 51

Gerstle v. *Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) 42

Gorman v. *Littlefield*, 229 U.S. 19 (1913) 53n

PAGE

Howard v. *Dun & Bradstreet, Inc.*, 136 Ga. App. 221, 220 S.E.2d 702 (Ct. App. 1975) 31n

Investment Corp. of Florida v. *Buchman*, 208 So. 2d 291 (Fla. Dist. Ct. App. 1968) 31n

J. I. Case Co. v. *Borak*, 377 U.S. 426 (1964) .....19, 20, 21, 25, 26, 33-35, 37, 38 & n, 39, 42, 44, 45, 47

Lank v. *New York Stock Exchange*, 548 F.2d 61 (2d Cir. 1977) 35, 59n

Leonard v. *Hunt*, 36 F.2d 13 (1st Cir. 1929) 54n

Luckenbach Steamship Co. v. *United States*, 315 F.2d 598 (2d Cir. 1963) 56, 57

Markham v. *Jaudon*, 41 N.Y. 235 (1869) 53n

Miller v. *New York Produce Exchange*, 550 F.2d 762 (2d Cir. 1977) 59n

National Railroad Passenger Corp. v. *National Association of Railroad Passengers*, 414 U.S. 453 (1974) 21, 42-44

Neely v. *Eby Construction Co.*, 386 U.S. 317 (1967) 51

Nortek, Inc. v. *Alexander Grant & Co.*, 532 F.2d 1013 (5th Cir. 1976) 31n

Piper v. *Chris-Craft Industries, Inc.*, 430 U.S. 1 (1977) 21, 30, 38n, 42

Richardson v. *Shaw*, 209 U.S. 365 (1908) 53n

Rogers v. *Atlantic, Gulf & Pacific Co.*, 213 N.Y. 246, 107 N.E. 661 (1915) 56, 58

Rondeau v. *Mosinee Paper Corp.*, 422 U.S. 49 (1975).... 26, 38n, 47

Ryan v. *Kanne*, 170 N.W.2d 395 (Iowa 1969) 32n

Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462 (1977) 51

SEC v. *Albert & Maguire Securities Co.*, 560 F.2d 569 (3d Cir. 1977) 60n

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Sexton v. *Kessler & Co.*, 225 U.S. 90 (1912) 53n

SIPC v. *Barbour*, 421 U.S. 412 (1975) 21, 25-26, 38n, 42, 44, 45

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PAGE

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The Beaconsfield, 158 U.S. 303 (1895) 56-57

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Wyandotte Transportation Co. v. *United States*, 389 U.S. 191 (1967) 26, 38n

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Bankrupcty Act (11 U.S.C. §§ 1 *et seq.*)

Section 21a, 11 U.S.C. § 44a 11

Section 60e, 11 U.S.C. § 96(e) 52-53

Section 167, 11 U.S.C. § 567 11

Fed. R. Civ. P. 17(a) .....57 & n

New York Stock Exchange Rule 325 9

New York Uniform Commercial Code Section 8-313(2) (McKinney's 1964) 53n

Securities Exchange Act of 1934 (15 U.S.C. §§ 78a *et seq.*) 3

Section 6, 15 U.S.C. § 78f 5, 35, 37, 38

Section 10(b), 15 U.S.C. § 78j 21

Section 13, 15 U.S.C. § 78m 42n

Section 14(a), 15 U.S.C. § 78n 21, 35, 37

Section 15, 15 U.S.C. § 78o 5

Section 17, 15 U.S.C. § 78q ..... *passim*

Section 18, 15 U.S.C. § 78r .....20, 21, 39, 41 & n, 42 & n

Section 19, 15 U.S.C. § 78s 5

Section 27, 15 U.S.C. § 78aa 13, 19, 25, 26, 32, 33, 41, 43, 47, 50n

PAGE

Securities Investor Protection Act of 1970 (15 U.S.C. §§ 78aaa *et seq.*) 1

Section 6(a)(1), 15 U.S.C. § 78fff(a)(1) 55

Section 6(c)(2)(B), 15 U.S.C. § 78fff(c)(2)(B) . 53, 54

Section 6(c)(2)(C), 15 U.S.C. § 78fff(c)(2)(C) . 53, 54

Section 6(f)(1), 15 U.S.C. § 78fff(f)(1) 48

Section 6(f)(1)(A), 15 U.S.C. § 78fff(f)(1)(A) .. 48

Securities Investor Protection Act Amendments of 1978 (Pub. L. No. 95-283, 92 Stat. 249 *et seq.*) 1, 48

Section 8, (§ 6(a)(1) as amended), 92 Stat. 259 55

Section 9, (§ 8(b) as amended), 92 Stat. 262 ..... 60n

Section 9, (§§ 8(c) (2), 8(d), 8(f) as amended), 92 Stat. 262-63, 265 48

Section 9, (§§ 9(a), 9(a)(1) as amended), 92 Stat. 265 48

Section 9, (§ 8(c) as amended), 92 Stat. 262-63 53

Section 15, (§ 16 as amended), 92 Stat. 272 53

Section 15, (§§ 16(4), (5) as amended), 92 Stat. 272 ..... 53, 54

Securities Exchange Act of 1934 Amendments of 1975 (Pub. L. No. 94-29, 89 Stat. 97 (1975)) 3n

Securities and Exchange Commission Rules

Rule 10b-5, 17 C.F.R. § 240.10b-5 ..... 24, 42, 45, 51

Rule 15c2-1, 17 C.F.R. § 240.15c2-1 55

Rule 15c3-1, 17 C.F.R. § 240.15c3-1 ..... 5, 55

Rule 15c3-3, 17 C.F.R. § 240.15c3-3 55

Rule 17a-5, 17 C.F.R. § 240.17a-5 ..... *passim*

PAGE

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78 Cong. Rec. 8039-8040 (1934) 41n

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H.R. Rep. No. 1409, 75th Cong., 1st Sess. (1937) 53

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S. Rep. No. 95-763, 95th Cong., 2d Sess. (1978) 49

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SEC News Digest (Aug. 8, 1957) 29

31 Vand. L. Rev. 1513 (1978) 45

Adv. Comm. Note to Fed. R. Civ. P. 17(a), 39 F.R.D. 69, 84-85 ..... 55, 57-58

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BRIEF OF RESPONDENT REDINGTON

Preliminary Statement

This brief is submitted by respondent Edward S. Redington, Esq. (the "Trustee"), in opposition to the brief of petitioner Touche Ross & Company ("Touche Ross"). The Trustee was appointed in May 1973 by order of the United States District Court for the Southern District of New York to liquidate Weis Securities, Inc. ("Weis") pursuant to the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa *et seq.* ("SIPA" or the "1970 Act").[1]

1. After this action was commenced, the Securities Investor Protection Act was amended in certain respects, Pub. L. No. 95-283, 92 Stat. 249 (1978). Where reference is made to provisions of the Act in existence before the amendments but not afterwards, the act will be called the "1970 Act."

Mr. Redington is one of the two plaintiffs in this action. A separate brief is being submitted by the Trustee's co-plaintiff, the Securities Investor Protection Corporation ("SIPC"). The two plaintiffs have sought to avoid duplication wherever possible.

Additional Statutes Involved

Section 27 of the Exchange Act, Sections 6(a)(1), 6(c)(2)(B) and 6(c)(2)(C) of the 1970 Act, and the relevant portions of the 1970 Act, as amended, Pub. L. No. 95-283, 92 Stat. 249 (1978), are set forth in the appendix at the end of this brief.

Counter-Statement Of The Questions Presented

1. Whether a private right of action based on Section 17 of the Exchange Act and the rules and regulations thereunder may be brought under Section 27 of the Exchange Act on behalf of the "favored wards" of Section 17—the customers of a brokerage house—when a firm of certified public accountants has made loss to customers unavoidable by preparing and certifying false and unduly favorable information about the broker's financial condition and failing to detect fraud in reports relied on by regulatory authorities under Section 17.

2. Whether the trustee of a brokerage house in liquidation under SIPA is a proper plaintiff and real party in interest to bring a Section 17 action for loss to customer property in his capacity as bailee of the separate fund of customer property established by SIPA, a fund of property distinct from the broker's own assets.

Counter-Statement Of The Case

This case involves the question whether Section 17 of the Securities Exchange Act of 1934[2] and the rules and regulations thereunder provide their intended beneficiaries —the customers of a brokerage firm whom Congress wished to encourage to participate in the nation's capital markets —with effective recourse for the easily identifiable customer losses caused by an accounting firm's reckless and grossly negligent failure to comply with Rule 17a-5. In the forced liquidation of Weis—a liquidation made unavoidable by the false representations and failure to detect fraud in the Rule 17a-5 reports certified by Touche Ross—significant sums of customer property have not been available to satisfy customer claims.

If a federal remedy does not exist, there is no assurance that state law provides a remedy that will restore these sums to customers. The petitioner's position in this very litigation has been that the Exchange Act preempts state law and prevents the state courts from even considering breach of duties under Rule 17a-5. Touche Ross has also taken the position that as a matter of law an accountant cannot be liable in the state courts to customers for any of the conduct, even gross negligence and recklessness, alleged in this complaint.

At the same time Touche Ross asks this Court to hold that it can never be liable in the federal courts—even for recklessness and gross negligence in performing Rule 17a-5 audits and failing to detect fraud. This is an extraordinary position. As the accountant fully understands when voluntarily undertaking to perform such an audit, the Rule 17a-5 audit is a cornerstone of the system for protecting

2. 15 U.S.C. §§ 78a *et seq.* (hereinafter the "Exchange Act"). References to the Exchange Act are to the Act as it existed in 1973. The Act underwent immaterial amendments in 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975).

brokerage house customers established by the Exchange Act. The issue before this Court is whether the customers protected by federal law have a meaningful remedy when they have suffered loss because an accountant's gross negligence and recklessness allowed fraud to be perpetrated upon customers and those who regulate brokers for their benefit.

Background Of The Litigation

This case arises on a motion to dismiss the complaint. Touche Ross, a large, national firm of certified public accountants, audited Weis and certified the adequacy of Weis' financial statements under Section 17 of the Exchange Act and the rules and regulations thereunder as at May 26, 1972. The complaint, which, as the Court of Appeals noted, sets forth the elements of the scheme to falsify Weis' financial condition "in great detail" (A193)[3] and the allegations of which must be accepted as true for the purposes of disposing of Touche Ross' motion to dismiss, alleges that the audit was performed in a negligent, grossly negligent and reckless manner.

In fact, the audit was performed so negligently that it failed to detect false, fraudulent and unsupportable entries in Weis' books and records; failed to discover or alert regulatory authorities to the existence of crude but substantial overstatements of Weis' profitability and net worth; and failed to discern, let alone disclose, misstatements of Weis' net capital ratio. Touche Ross gave the documents filed by Weis with regulatory authorities a clean, unqualified certificate. Yet less than one year after the audit was completed, Weis had to undergo a forced, bankruptcy-type liquidation. This liquidation, the largest ever conducted under SIPA and the only one to date involving

3. References to "A " are to pages of the Appendix submitted with petitioner's brief.

a New York Stock Exchange member firm, was necessary because of the sudden revelation of a precarious, deteriorating financial condition which had existed at Weis since 1972 and because no reliance could be placed on any of Weis' recent books of account, records or financial statements, including those relevant to the protection of customer property and previously certified by Touche Ross.

Requirements Of Section 17 And Rule 17a-5

As a broker-dealer in securities and a member of the New York Stock Exchange, Inc. (the "Exchange"), Weis was subject to regulation for the benefit of customers under the Exchange Act by the Securities and Exchange Commission (the "SEC") and by the Exchange in its capacity as a self-regulatory organization. *See* Exchange Act §§ 6, 19, 15 U.S.C. §§ 78f, 78s.

Among the regulations to which Weis was subject were the statutorily required "net capital" and related financial responsibility rules of the SEC and the Exchange. Exchange Acts §§ 15, 17, 15 U.S.C. §§ 78o,q; SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1; NYSE Rule 325. As the Court of Appeals observed, these rules and statutes are part of a statutory scheme designed to ensure that brokers are adequately capitalized and can satisfy customer claims on demand. (A197.)

The whole purpose of this extensive system of financial responsibility statutes and rules and regulatory supervision is to build confidence in the operation of capital markets and to encourage people to invest in securities. People have to deposit property with broker-dealers in order to participate in the securities markets. Congress wished to relieve these people of the burden of having to make sophisticated judgments about a particular broker-dealer's financial well-being and to remove the risks that the particular broker to which a customer entrusted his life's savings followed deceitful

practices or operated with insufficient capital. In this way the average man in the street would be encouraged to become a customer and participate in the nation's capital markets. *See* S. Rep. No. 1455, 73d Cong., 2d Sess. 12-15 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3 (1934).

The requirements of Section 17 and the rules and regulations thereunder, particularly SEC Rule 17a-5, 17 C.F.R. § 240.17a-5 ("Rule 17a-5") relating to audited financial statements and accountants' certificates, are the cornerstones of the financial responsibility rules. As the Court of Appeals noted:

> "It is the reporting system created by Section 17 that provides the SEC and other regulatory authorities with the information needed to enforce the net capital rule. Thus, a failure to supply accurate reports will leave the customers without protection until the broker's insolvency can no longer be concealed, and liquidation follows." (A198.)

Because of the pivotal role played by Rule 17a-5, the Rule has always required accounting firms to make specific representations about the scope of their audits and the nature of their opinions with respect to broker-dealers' statements of financial condition. The Rule is especially specific with respect to those areas of an accounting firm's examination relating to a broker's compliance with rules adopted for the protection of customers.

At the time Touche Ross rendered auditing services for Weis, for example, Rule 17a-5(g)(2) required the accountant to identify in its certificate the items of the report covered by the certificate and required the accounting firm to give a "reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers * * *." The Rule also specifically required the accountant to evaluate, and

report to the regulatory authorities upon, the broker's system of internal accounting control. The Rule not only required the accountant to state "whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances;" it also required him to state "whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case." And lest there be any mistake about the auditor's responsibility, subparagraph (g)(3) concluded with the warning that no authority could be implied for omitting any procedures which would normally be employed by independent accountants in order to make the certifications required by the Rule.

In addition to these duties, subparagraph (i) placed a specific duty on accounting firms such as Touche Ross to flag potential trouble spots by providing: "Any matters to which the accountant takes exception shall be clearly identified; the exception thereto shall be specifically and clearly stated; and to the extent practicable, the effect of each such exception on the related item of the report shall be given."

Touche Ross voluntarily undertook, and was paid, to perform all the accounting and auditing services necessary to certify Weis' "Answers to Financial Questionnaire" and other documents for Weis' fiscal year ended "as at May 26, 1972." After supposedly performing all the necessary services in May, June and July of 1972, Touche Ross signed opinion letters with respect to four different financial documents, including the Answers to Financial Questionnaire required to be audited and certified by Rule 17a-5. (A37, A45, A69, A87.) In the opinion letter with respect to the Answers to Financial Questionnaire, Touche Ross falsely stated that it had performed all the auditing steps prescribed by regulatory authorities. (A45.) Touche Ross also falsely certified without qualification the reliability both of Weis' financial and income statements and of its

internal system of accounting control. (A64-65.) On the latter point, Touche Ross concluded that its "study and evaluation disclosed no conditions that we believe to be material weaknesses." (A65.)

The Touche Ross audit thus gave the Weis financial statements and internal accounting systems the cleanest bill of health: an unqualified opinion. The Touche Ross opinions expressed no hint of an exception or disclaimer, not one syllable of qualification. As noted above, Rule 17a-5 required Touche Ross not only to state its opinion with respect to the Answers to Financial Questionnaire (Rule 17a-5(h)), but also to state "specifically and clearly" any "exception" it had to any of the matters covered in its opinion (Rule 17a-5(i)) and to state specifically whether it had omitted any necessary procedures in the course of its audit. (Rule 17a-5(g)(2)(iii).) The dearth of negative comment in its certificates was thus one of the most significant things about the Touche Ross opinions.

Non-Disclosure Of Fraud In The Documents Certified By Touche Ross

The documents certified by Touche Ross were filed with regulatory authorities, and summaries of financial condition based upon them were distributed to customers. Despite the representations in the Touche Ross opinions, the reports audited and certified by Touche Ross "as at May 26, 1972" proved in fact to be materially false and misleading in many respects. Far from being subject to an adequate system of internal control, the Weis records had been manipulated through a crude and easily detectable series of accounting entries by a cadre of five Weis officers and financial personnel to disguise substantial operating losses and an unsatisfactory and rapidly deteriorating net capital ratio and financial position. (A7-8, A16-19.) For example, although the income statements certified by

Touche Ross reflected an ostensible pre-tax profit of $1,700,000, Weis had in fact lost at least $1,500,000; every report certified by Touche Ross, including the Answers to Financial Questionnaire, misstated Weis' net worth and net capital position by substantial amounts. (A8, A19-20.)

These false entries, undetected by Touche Ross despite the unqualified representations about the scope of its audit, infected not only the statements dated "as at May 26, 1972" but every report, statement or summary of financial condition thereafter filed with the Exchange and the SEC, distributed to customers and shown to Weis' board of directors. Once given the *imprimatur* of Touche Ross, Weis' system of internal control continued to be manipulated to disguise from regulatory authorities as well as Weis' board of directors and customers Weis' deteriorating financial position and net capital problems throughout the rest of 1972 and early 1973. (A8-9.)

Finally, after learning through confessions of a conscience-stricken member of the Weis five in May of 1973 of the fraudulent disguising of Weis' true financial condition and the lack of reliability of any of its records,[4] the

4. The story of the events immediately preceding Weis' liquidation is set forth in the Trustee's report to the Bankruptcy Court, of which petitioner asks the Court to take judicial notice. (T.R. Br. at 83 n.47.)

Touche Ross notes (T.R. Br. at 10 n.7) that the SEC, in its action for injunctive relief against Weis and some of its officers, did not also allege securities acts violations against Touche Ross, and that the subsequent criminal indictments filed against the Weis five asserted that these employees had deceived Touche Ross about the falsification of Weis' books and records. The SEC's complaint, however, did not follow a substantial period of investigation, and instituting an injunctive proceeding against Touche Ross on May 24, 1973 would have been a meaningless distraction which would have had no effect on protecting Weis' customers. Similarly, the United States attorney who secured indictments against the Weis five was concerned with painting their criminal conspiracy in the most nefarious colors, not in passing judgment on the adequacy of Touche Ross' auditing procedures or its civil responsibility. The Trustee has never contended that Touche Ross should be held

SEC sought to enjoin Weis and its officers from further violating the Exchange Act; at the same time SIPC sought a decree declaring Weis' customers in need of protection under the 1970 Act. On May 30, 1973, Weis' liquidation was ordered and the Trustee appointed. (A9-10.)

The Weis Liquidation And The Filing Of The Federal Action

The liquidation of Weis under SIPA is a bankruptcy-type proceeding. In addition to satisfying general creditors' claims out of the general property of the debtor, as in a normal bankruptcy, the Trustee in a SIPA liquidation has special duties to marshal and distribute to customers (including SIPC, as statutory subrogee of customers whose claims have been satisfied with SIPC cash advances) a separate fund composed of customer property entrusted to the debtor in a purely custodial capacity by its customers. Because of the delay in the exposure of Weis' financial condition, customer property in the Weis liquidation has been insufficient by several million dollars[5] to satisfy customer claims. In April of 1976, the Trustee and SIPC commenced this action in federal court under Sections 17 and 27 of the

criminally responsible for the Weis *debacle*, only that it should respond in damages for palpable violations of Rule 17a-5 and the standard of care expected of certified public accountants. It is because regulatory authorities cannot evaluate the auditor's performance without conducting prolonged and almost inevitably untimely investigations of their own that private damage actions are an indispensable supplement to SEC and Exchange enforcement activities.

5. At the time the complaints were filed, the deficit in the fund of customer property amounted to some seventeen or eighteen million dollars, fourteen million of which would ultimately be returnable to SIPC as subrogee, the rest to customers with claims against the fund of customer property which exceeded the statutory limits for SIPC cash advances. Subsequent marshalling of assets and recoveries in other litigations by the Trustee have reduced by approximately one-third the amount of the fund deficit that will be sought on behalf of customers at the time of trial.

Exchange Act to recover this deficit in the fund of customer property as well as to recover general damages sustained by Weis as a corporate entity. The filing of the action was preceded by a lengthy investigation by the Trustee under Sections 21a and 167 of the Bankruptcy Act (11 U.S.C. §§ 44a, 567) which included subpoenaing and reviewing the work papers prepared by Touche Ross in its 1972 audit.

The Federal Action

In a common section of the complaint, both plaintiffs allege that Touche Ross assumed specific duties and obligations under Section 17 and Rule 17a-5 when it accepted the engagement to be Weis' auditor and undertook to perform all necessary auditing and accounting services required to certify Weis' Answers to Financial Questionnaire and related documents. The complaint alleges not only that Touche Ross was negligent, grossly negligent and reckless in performing these duties and failing to detect fraud, but also that it falsely certified that it had performed all appropriate services and falsely represented that it could give opinions—for which it had no basis in fact—about the Answers to Financial Questionnaire, report on internal control and other documents dated as at May 26, 1972. (A7-21.)

The Trustee's section of the complaint sets forth six claims for relief. (A21-24.) One of these claims is based on Section 17, and the jurisdiction of the federal court is invoked under Section 27. (A6, A21-22.) Five other claims are based on state law concepts of negligence, breach of contract, and the like. (A22-24.) Jurisdiction over the five other claims is based on pendent jurisdiction and various jurisdictional provisions of the Bankruptcy Act and SIPA. (A6.)

The Trustee's Section 17 claim alleges that Touche Ross violated Section 17 itself, by performing its duties under

Rule 17a-5 negligently and recklessly, and also that Touche Ross aided and abetted Section 17 violations by the five miscreant Weis employees. (A21-22.) The damages claimed in the Trustee's section of the complaint include both the amount necessary to satisfy the deficit in the fund of customer property and the amount of general damages suffered by Weis as a corporate entity. (A22.) The Court of Appeals has held, however, that only the amount necessary to restore the fund of customer property—not damage suffered by Weis as a corporate entity—may be recovered under Section 17 (A202-04), and the Trustee has not sought review of this ruling. Thus the Trustee's Section 17 claims are asserted solely in his capacity as bailee and are asserted on behalf of customers, not Weis.

SIPC, in a separate section of the complaint, alleges eight claims for relief, one of which is also based on Section 17 of the Exchange Act. (A24-31.) SIPC seeks to recover directly, as subrogee of customers, some of the same damages claimed by the Trustee for the purpose of replenishing the fund of customer property. Since the Court of Appeals held that SIPC was an appropriate party to recover these amounts, the Trustee's claims are currently limited to that part of the fund deficit representing claims of customers which remain unsatisfied through SIPC cash advances. (A201-02.) If SIPC were determined to have no right to sue directly in its own behalf, the Trustee, as bailee of the fund of customer property, would be an appropriate plaintiff to sue for the damages claimed by SIPC. As between the Trustee and SIPC, it is of no importance which entity recovers this amount.

The State Court Action

Approximately one year before the filing of their federal action, SIPC and the Trustee commenced a parallel but less comprehensive action in the state court. The state court

action was commenced at that time as a precautionary measure, to guard against any possible running of a state statute of limitations. The state court action was "commenced" before the federal action only in a very technical sense: a summons without complaint was served as permitted in the New York State courts. (A121-22.) Thereafter nothing happened for nearly a year. The complaint in the state court action was actually served and filed after the commencement of the federal action. (A5, A123.) Limited discovery and motion practice have been conducted in the state court action but, as noted by the Court of Appeals (A195 n.7), proceedings in that court have been held largely in abeyance by agreement of the parties pending resolution of the jurisdictional issues in the more comprehensive federal action.

Touche Ross argues that the state court action is virtually identical to this one. (T.R. Br. at 6.) However, while the factual allegations of the two complaints are nearly verbatim, the state court action is dissimilar in one crucial respect: no claim for a direct violation of Rule 17a-5 is made by either plaintiff in the state court because Section 27 of the Exchange Act (15 U.S.C. § 78aa) makes the jurisdiction of the federal courts exclusive in such matters. This difference is important because (a) it affects the ability of either plaintiff to sue directly for violations of the duties imposed by Rule 17a-5 (as opposed to suing for violations of a state law duty of reasonable care based on considerations other than Rule 17a-5) and (b) because it affects the ability of either plaintiff to sue directly for the harm caused to the fund of customer property (as opposed to suing for harm done to Weis as a corporate entity).

State law provides no guarantee that effective remedies for customers exist for Section 17 violations. This point is illustrated by positions taken by Touche Ross in motions to dismiss totalling hundreds of pages which it has served

on SIPC and the Trustee in both the District Court in this action and in the state court action.[6] These positions belie the arguments about appropriateness of state court remedies which Touche Ross has made in this Court. In those motions Touche Ross made the following arguments:

> 1. SIPC has no standing to sue, whether on its own behalf or as subrogee of customers, based on the allegations made in its part of the complaint (Memorandum of Defendant Touche Ross & Co. in Support of Motion to Dismiss and for Related Relief, filed with the district court on September 22, 1976, at 128-40, 152-55);
>
> 2. Customers and those who represent them cannot sue accountants for negligence, gross negligence or anything less than willful misconduct under New York law; fraud would have to be alleged before customers who are not in privity of contract with accountants could even arguably state a cause of action under New York law (*id.* at 142-52); and
>
> 3. Violations of duties assumed by accountants under Rule 17a-5 cannot be considered under the law of any state because Section 27 of the Exchange Act provides that the federal courts have exclusive jurisdiction over proceedings to enforce duties and obligations created by that Rule. (*Id.* at 114-20.)

Touche Ross does appear to concede that state courts might theoretically permit some relief to the Trustee in negligence, but any relief that might be afforded to him would be afforded solely on behalf of Weis as the corporate entity actually in privity of contract with Touche Ross, not

6. The motion in the state court action was subsequently withdrawn without prejudice to its renewal as part of a series of stipulations deferring almost all activity in the state court until the question of jurisdiction was resolved in the federal courts. The District Court never reached these issues because of its decision on Section 17 and the other jurisdictional issues.

on behalf of Weis' customers.[7] Thus when Touche Ross argues in this Court that state law remedies are "adequate" or "appropriate," what it means is that state law remedies are appropriate as far as Touche Ross is concerned because they afford virtually complete immunity to accountants against customers' claims—not because they hold out any hope of protection for customers. The accountant's real "bottom line" in the state courts is that an accountant can *never* be held liable to customers or their representatives for violations of duties assumed under Rule 17a-5.

The Opinions Below

The District Court (Wyatt, J.) dismissed the complaint in the federal action, holding without reference to the actual content of Rule 17a-5 that "Section 17 was designed to supply administrative guidance in the bookkeeping area and not to create any rights in anybody" (A177), and that neither the Trustee nor SIPC was "meant to be protected" by that statute. (A183.) The Court also rejected the Trustee's alternative jurisdictional arguments based on various provisions of SIPA and the Bankruptcy Act. (A184-86.) The Court dismissed all the pendent state law claims without reaching Touche Ross' arguments that most of those claims were not viable as a matter of state law.

The Court of Appeals reversed on the Section 17 questions in a 2-to-1 opinion. After carefully considering the opinion of the district court and the prior decisions of this Court, Judge Lumbard, writing for the majority, held that a private right of action exists under Section 17 and that the two plaintiffs could sue to restore the fund of customer property.

7. Even here, the accountants have made it clear that they will argue that the Trustee's rights should be diminished or defeated by the conduct of the Weis five—conduct having nothing to do with the equities of Weis' customers.

Focusing on the language of Section 17, the duties imposed on accountants under that section and Rule 17a-5 and the role played by accountants in the regulation of brokers, the Court of Appeals reasoned that Weis' customers were members of a class of persons protected by Section 17 and that implying a private right of action on their behalf was "an essential supplement to the scheme of enforcement of Section 17." (A200.)

The court rejected the notion that Section 18 of the Exchange Act—a section creating rights in investors who trade in a particular issuer's stock—provided an exclusive remedy for violations of Section 17, a provision designed to protect investors in a completely different capacity, as customers of a brokerage firm:

> "Since any misstatement in a Section 17 report would not affect the price of the shares of the various issuers in the hands of a broker's customer, a strict application of Section 18's limiting language would leave customers without any remedy whatsoever, no matter how egregious the fraud or how grievous their loss. Yet it is plain that brokers' customers are favored wards of Section 17. We cannot agree that Congress simultaneously sought to protect a class and deprived the class of the means of protection." (A200.)

The court below also rejected the notion that an injury resulting from accountant's violation of Rule 17a-5 should be relegated exclusively to the vagaries of state law:

> "Section 17 is part of a statute as to which federal courts have exclusive jurisdiction; state law protection of brokers' customers varies widely. There is no reason to believe that the remedy sought herein is one traditionally relegated to state law." (A200.)

The court below held that the Trustee could not sue under Section 17 on behalf of Weis for harm done to it as a corporate entity, but that the Trustee did have capacity to sue and was the real party in interest under Section 17 in his capacity as bailee of the fund of customer property entrusted to Weis by its customers. (A202-04.) The court below also sustained SIPC's capacity to sue directly as subrogee to the extent it has made cash advances to customers for which it has not been reimbursed from the fund. (A201-02.)

Although Touche Ross argues that the type of *scienter* that must be alleged to recover under Section 17 is a question before this Court, the Court of Appeals specifically left this issue for consideration by the District Court on remand. (A204.) The court also remanded for consideration by the District Court questions relating to pendent jurisdiction over non-Section 17 claims and Touche Ross' argument that the federal action should be stayed in favor of the less comprehensive state court action. (A204.)[8]

Touche Ross' petitions for rehearing and suggestion for rehearing *en banc* were both denied by the Second Circuit. (A227-28.) In the certiorari petition that followed in this Court, Touche Ross did not address the *scienter* question even in a footnote.

Summary of Argument

I.

Customers are the persons for whose "especial benefit" Section 17, Rule 17a-5 and an entire system of broker-dealer regulation were created by the Congress. These provisions

8. The Court of Appeals stated that its decision sustaining federal jurisdiction over the Trustee's Section 17 claim made it unnecessary to consider the Trustee's position regarding the District Court's bankruptcy court jurisdiction over these other claims. (A192n.3.) As set forth in the Trustee's cross-petition for certiorari, filed September 27, 1978, and still *sub judice*, that position amply supports federal jurisdiction over this case.

of law were designed to encourage investment by building investor confidence in the operation of capital markets. Other provisions of the Exchange Act are designed to ensure that investors receive accurate information about the financial condition of companies whose securities they purchase; Section 17 and the financial responsibility rules serve a different purpose: encouraging investors to entrust cash and securities to brokerage firms—the middlemen with whom the investor must deal in order to participate in the nation's capital markets. Section 17 is not unique in this regard. Section 6 of the Exchange Act is another provision intended to ensure proper operation of capital markets by imposing upon national securities exchanges the duty to regulate conduct of member brokerage firms. In a long line of cases beginning with the decision of Judges Swan, Augustus Hand and Clark in *Baird* v. *Franklin,* 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944), the federal courts have recognized that private actions by customers against stock exchanges for violation of their Section 6 responsibilities are essential to the underlying purposes of the Exchange Act. The same logic compels recognition of a private action against accountants in this case.

Accountants play a central role in the regulatory scheme of Section 17, designed to ensure the safety of property entrusted to broker-dealers by customers. Unless regulatory authorities are to hire, train and supervise legions of their own auditors, accurate periodic audits by independent accountants must be relied on as the keystone of the entire regulatory structure. Regulatory authorities cannot and should not audit the auditors to avert financial disasters in advance; they can and should be able to take the auditors' certificate under Rule 17a-5 at face value in conducting their own monitoring of the broker. If the accounting firm fails to detect and alert regulatory authorities to the existence

of fraud, grave problems affecting customers will not be discovered, let alone acted upon, until disaster has become irreversible. Although sanctions can be imposed upon such grossly negligent accountants in the wake of a brokerage firm insolvency, such punitive measures will offer no compensation to investors who entrusted cash and securities to the brokerage firm and found that there were insufficient assets when disaster was discovered. Thus, as the court below correctly recognized, a private action to recover customer losses that might have been avoided by a proper audit is essential to promote the confidence of investors that they may participate in capital markets through broker-dealers.

The enforcement of accountants' obligations in the regulatory structure created pursuant to Section 17 cannot be left to state law. Touche Ross has itself argued below and in the related state litigation that customers and those representing them cannot recover for losses caused by the gross negligence of accountants because customers are not in privity with the auditors. Touche Ross has also argued that the exclusive jurisdiction provision of Section 27 prevents violations of Rule 17a-5 duties from even being considered in evaluating Touche Ross' conduct under state law. But even if all these obstacles to making customers whole in the state courts could somehow be surmounted in this case, the need for a federal remedy would still remain. The protection of customers for losses in a brokerage firm liquidation should not turn on whether state law happens to be liberal or conservative with respect to areas of the law such as malpractice.

A convincing expression of Congress' intent is Section 27 of the Exchange Act, a provision giving the federal courts exclusive jurisdiction over "suits in equity and actions at law" to enforce duties created by Exchange Act rules. As this Court stated in *J. I. Case Co.* v. *Borak,* 377 U.S. 426 (1964), Section 27 provides ample warrant for

recognition of private rights of action which, like this one, are consonant with the specific goals of specific sections of the Exchange Act. In withdrawing actions to enforce provisions such as Rule 17a-5 from the state courts and the vagaries of state law and state procedure, Congress made it imperative to recognize federal rights of action for customers who would otherwise have no remedy at all. As the Court below noted, it would be imputing a Pickwickian logic to the Congress to suppose that it "simultaneously sought to protect a class and deprived the class of the means of protection." (A200.)

II.

A.

Touche Ross virtually concedes in its brief that under the principles applied by this Court in cases like *J. I. Case Co.* v. *Borak, supra, Texas & Pacific Ry.* v. *Rigsby,* 241 U.S. 33 (1916) and *Cort* v. *Ash,* 422 U.S. 66 (1975), the decision below permitting a private right of action by the Trustee and by SIPC must be affirmed. But Touche Ross believes that the foregoing analysis under Section 17 must be discarded because an adjacent section of the Exchange Act, Section 18, gives purchasers and sellers of securities a private right of action for false statements contained in "reports" filed pursuant to the Act or rules and regulations thereunder. Touche Ross contends that Section 18 furnishes the exclusive remedy for injuries caused by false statements in any accountant's "report" pursuant to Rule 17a-5.

The fortuitous juxtaposition of these two statutes, and their common use of the common word "reports," is no meaningful indicium of Congressional intent. Section 18 is concerned with investors not in their role as *customers* of a brokerage firm, but in their role as *traders* in the stock of issuing companies. Like certain other Exchange Act provisions, Section 18 is designed to assure that investors in a company receive accurate information relevant to their

trading decisions. Because Section 18 is not addressed to investors in their capacity as customers of a broker-dealer, it does not evidence any intent to withhold a damage remedy from customers when necessary to redress violations of other provisions of law designed to assure the solvency and proper operations of the middlemen of capital markets. Touche Ross' argument that Section 18 is exclusive, without regard to the different purposes served by various sections of the Exchange Act, is inconsistent with this Court's prior decisions. The Court has already found that private rights of action are available for violations of Section 10b and Section 14a of the Exchange Act. *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975); *J. I. Case Co.* v. *Borak, supra.* These holdings cannot be reconciled with the argument that Section 18 is exclusive. In *Piper* v. *Chris-Craft Industries, Inc.* 430 U.S. 1 (1977), this Court held that an unsuccessful tender offeror could not maintain a private damage suit for false statements in a registration statement—which was also a "document filed pursuant to this title" as described by Section 18—not because of any "exclusivity" of Section 18 but because an analysis of the statute and legislative history showed that Congress intended to protect target company shareholders, not unsuccessful offerors.

Far different considerations led this Court to invoke the *expressio unius* principle in *SIPC* v. *Barbour,* 421 U.S. 412 (1975), and *National Railroad Passenger Corp.* v. *National Association of Railroad Passengers,* 414 U.S. 453 (1974), the cases most directly relied upon by Touche Ross. In those cases government intervention had been entrusted exclusively to the discretion of supervised, public entities which were expected to balance competing interests in reaching regulatory decisions. Here, by contrast, the obligations of accountants are prescribed by rule and statute. It is the business of courts to determine whether persons have measured up to their duties.

B.

Recognition of a private right of action on behalf of these two plaintiffs under Section 17 will not produce any of the "imaginary evils" that Touche Ross has conjured up. *Cf. United States* v. *Lee,* 106 U.S. 196, 217 (1882). The federal courts will not be inundated with litigation. The kinds of customer losses for which the Trustee and SIPC seek recovery will occur only in the case of large brokerage firm insolvencies, of which there have been very few. Indeed, Weis represents the only SIPC liquidation of a NYSE member firm.

The concerns that led this Court in *Blue Chip Stamps* v. *Manor Drug Stores, supra,* to recognize the continued validity of a purchaser-seller rule in 10b-5 actions are also not presented by this case. Recognition of the private right of action brought by SIPC and the SIPA Trustee will not lead to " 'liability in a indeterminate amount for an indeterminate time to an indeterminate class.' " *Blue Chip Stamps, supra,* 421 U.S. at 748, *quoting Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 179, 174 N.E. 441, 444 (1931). There are only two plaintiffs here, and the damages they seek under Section 17 are determinate: the value of the customer property that had been entrusted to Weis by its customers but was not in the hands of Weis at the time of liquidation. Liability can be calculated to the penny from the records of the Bankruptcy Court. A Pandora's box of problems of proof will not be opened if a private right of action is recognized on behalf of these two plaintiffs. *Compare* 421 U.S. at 743. There will be no unleashing of the winds of vexatious litigation; a government corporation and a SIPA Trustee subject to supervision by the Bankruptcy Court are not going to bring suits for their "nuisance value". *Compare* 421 U.S. at 740-41. This suit was brought only after the Trustee, acting with the subpoena power of the Bankruptcy Court, had conducted a lengthy investigation of Weis' affairs and Touche Ross' work papers.

Touche Ross raises the specter that if the Trustee and SIPC are permitted to sue, then customers will sue seeking

consequential and incidental damages other than loss of the value of property in their brokerage firm accounts. No such claims are before the Court in this case. No such claims are likely to come before the courts in the future. Incidental and consequential damage claims can arise only when there is a brokerage firm liquidation and customer accounts cannot be salvaged or customers made whole from SIPC advances and fund properties. Recent amendments to SIPA have expanded the limits of advances SIPC is authorized to make to each customer and have given SIPA Trustees increased powers to deliver promptly to customers their accounts in the exact form that they existed prior to liquidation. In any event, if customer suits and speculative damage claims similar to those which concerned the Court in *Blue Chip Stamps* are presented in future cases, these difficulties may be remedied as in *Blue Chip Stamps,* by limiting the damages that may be claimed or limiting suits to SIPC and Trustees. In short, such difficulties can be met by discriminating judicial doctrine, not by wholesale denial of any opportunity for compensation, as Touche Ross urges.

Finally, there is no merit to Touche Ross' argument that allowing a private action to be maintained against it will make accountants, rather than SIPC, the "insurer" of brokerage firm performance. SIPC was established to deal with brokerage firm insolvency dislocations not addressed by other statutes, not to restrict the liability of those that unjustifiably caused those insolvencies. Allowing a private action to be maintained against Touche Ross will not make it the "insurer" of Weis' misfortune, but will only hold it responsible for failures to perform its statutory and regulatory duties.

C.

Touche Ross argues that the Court should decide whether, and to what degree, *scienter* must be established

in order to sustain a Section 17 violation. This issue, however, was not considered by either of the courts below, does not appear to have been fairly comprised within the petition for writ of certiorari, and therefore should not be considered at this time by the Court.

In any event, there is no reason that any conduct more willful than that alleged in the complaint—negligence, gross negligence and recklessness—should be required. Even under an anti-fraud provision such as Rule 10b-5 this Court has recognized that recklessness might be sufficient to establish Exchange Act liability. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 193-94 n.12 (1976). Rule 17a-5, unlike Rule 10b-5, is not an anti-fraud provision. It does not speak in terms of schemes and artifices to defraud but in terms of prescribed duties and obligations which accountants certify that they have performed. An inexcusably lax or grossly negligent accountant can be as destructive to customer property as a reckless or dishonest one, and should be held accountable to customers.

III.

There can be little doubt that the Trustee is a proper plaintiff and real party in interest to sue in his capacity as bailee of customer property. The fund of customer property administered by the Trustee under SIPA consists of property entrusted to the debtor by customers in a custodial capacity and is not considered part of the general assets of the debtor as are, for example, funds or property loaned to a brokerage house by its creditors. Weis as a going concern, and the Trustee after its liquidation, are in a bailor-bailee relationship with customers with respect to this fund of customer property. It is axiomatic that a bailee can sue for harm or loss to the bailed property, holding any recovery in trust for his bailors. That is the only capacity in which the Trustee seeks to pursue his Section 17 claim for relief.

Argument

I.

A PRIVATE RIGHT OF ACTION UNDER SECTIONS 17 AND 27 OF THE EXCHANGE ACT IS NECESSARY TO PROTECT CUSTOMERS FOR LOSSES THAT CANNOT BE PREVENTED WHEN AN ACCOUNTANT DOES NOT COMPLY WITH RULE 17a-5.

A. Accountants Performing Rule 17a-5 Audits Assume Important Duties For The Benefit Of Customers Which Are Enforceable In "Actions At Law" Under Section 27.

Section 27 of the Exchange Act, 15 U.S.C. § 78aa, provides for exclusive jurisdiction in the federal courts over "suits in equity and actions at law" brought to enforce the duties or liabilities created by the Act:

> "The district courts of the United States, * * * shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder * * *"

Recognizing the significance of Section 27 to the question whether a private right of action exists under those sections of the Exchange Act not specifically providing for one, this Court in *J. I. Case Co.* v. *Borak,* 377 U.S. 426, 430, 433 (1964), held that a private right of action existed under Section 14(a) of the Exchange Act because it was "clear that private parties have a right under § 27 to bring suit for violation of § 14(a) of the Act" since Section 27 "specifically grants the appropriate District Courts jurisdiction over 'all suits in equity and actions at law brought to enforce any liability or duty created' under the Act." (377 U.S. at 430-31.) *See also SIPC* v. *Barbour,* 421 U.S. 412,

424 (1975). The guiding principle underlying such an application of Section 27 is that it be used to provide appropriate remedies to enforce the duties imposed by other sections of the Act:

> "It is for the federal courts 'to adjust their remedies so as to grant the necessary relief' where federally secured rights are invaded. 'And it is also well settled that where legal rights have been invaded, and a federal statute provides for a general right to sue for such invasion, federal courts may use any available remedy to make good the wrong done'." (*J. I. Case Co.* v. *Borak, supra,* 377 U.S. at 433, *quoting Bell* v. *Hood,* 327 U.S. 678, 684 (1946).)

See also Rondeau v. *Mosinee Paper Corp.,* 422 U.S. 49, 62-63 (1975); *Deckert* v. *Independence Shares Corp.,* 311 U.S. 282, 288 (1940).

This principle was elaborated upon in *Wyandotte Transportation Co.* v. *United States,* 389 U.S. 191, 202, 204 (1967) as follows:

> "Because the interest of the plaintiffs in those cases fell within the class that the statute was intended to protect, and because the harm that had occurred was of the type that the statute was intended to forestall, we held that civil actions were proper. That conclusion was in accordance with a general rule of the law of torts. See Restatement (Second) of Torts § 286. * * *
>
> * * *
>
> Denial of such a remedy * * * would permit the result, extraordinary in our jurisprudence, of a wrongdoer shifting responsibility for the consequences of his negligence onto his victim. It might in some cases permit the negligent party to benefit from commission of a criminal act. We do not believe that Congress intended to withhold * * * a remedy that ensures the full effectiveness of the Act."

See also Bivens v. *Six Unknown Named Agents of Federal Bureau of Narcotics,* 403 U.S. 388, 392 (1971); *id.* at 402-03 n.4 (Harlan, J., concurring); *Texas & Pacific Ry.* v. *Rigsby,* 241 U.S. 33 (1916).

Rule 17a-5 clearly places duties on accountants who undertake to perform brokerage house audits. The rule addresses directly what an accountant must do and identifies the specific duties that he must certify that he has performed, especially as the audit involves the broker's compliance with the rules regarding segregation of customer property and other customer protection provisions. As set forth in greater detail above (*supra* at 6-8), subparagraphs (g) through (i) of the Rule require not only that the accounting firm certify that it has performed certain specific accounting and auditing procedures with respect to a broker's Answers to Financial Questionnaire, but they also require it to state in its certificate any exceptions or auditing steps that have been omitted. While nothing in Section 17 or Rule 17a-5 may compel an accountant to undertake a Rule 17a-5 audit, the accountant, once he has engaged himself to conduct such an audit, must be deemed to have assumed a duty to do everything that the Rule requires. This Court recognized the duties accepted by accountants under Rule 17a-5 in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 188 n.1 (1976).

As the accountant is well aware, these duties serve an important public purpose in the scheme of customer protection established by Congress in the Exchange Act. Regulatory authorities cannot scrutinize in minute detail the data underlying the figures reported by every brokerage house in the United States to assure themselves of the accuracy of the information used for regulatory purposes. Instead, certified public accountants voluntarily agree, and are paid, to perform this service. If, as here, the accountant files unqualified certificates but has failed to perform the required services that would have detected

false record-keeping and crude but material misstatements of profitability, net worth and net capital ratios, the early warning system created to prevent loss to customers cannot function in time to prevent financial collapse and loss to customer property. It is necessary to protect customers that the accountant respond in damages for the loss that could have been prevented had he performed a minimally acceptable audit.

B. Customers Are An "Especial Class" Protected By Rule 17a-5.

It is beyond dispute that the duties imposed on accountants by Rule 17a-5 were designed to protect the customers of broker-dealers. Section 17 and Rule 17a-5, which was promulgated thereunder, were promulgated "as necessary or appropriate in the public interest or for the protection of investors." Exchange Act § 17, 15 U.S.C. § 78q. The Rule's requirement that a brokerage firm have financial statements appropriately audited by independent accountants has always served as the keystone for the "early warning system" of brokerage firm financial problems and, indeed, of the entire statutory scheme by which the financial condition of brokers and dealers is regulated for the protection of investors. *See e.g., Boruski* v. *SEC,* 340 F.2d 991, 992 (2d Cir.), *cert. denied,* 381 U.S. 943 (1965); Report and Recommendations of the Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231, 92d Cong., 2d Sess. 24-27, 31 (1971).

Commenting on the requirement of audited financials in *Boruski* v. *SEC, supra,* for example, the Second Circuit stated:

> "The regulations are not shown to be unreasonable; indeed, it is difficult to see how the Commission could carry on its task of protection of the public investor without financial information such as it sought here." (340 F.2d at 922.)

And when the SEC amended Rule 17a-5 in 1957 it explained that the amendment was to:

> "[a]dd another important protective feature to the Commission's continuing program for improving the safeguards afforded to customers of broker-dealer firms * * *. The Commission believes that *it is essential, for the protection of public investors, that the accounts of these broker-dealers who do business with the investing public and handle customer funds and securities be subject to an annual audit by an independent accountant.*" (SEC News Digest (Aug. 8, 1957) at 3.) (Emphasis added.)

The Commission also noted that insofar as the amendments expanded the certification requirements in the Rule they:

> "represented the Commission's considered view that those certification and reporting requirements constituted a valuable regulatory tool *for the protection of a customer in respect of the risks involved in leaving his money and securities with his broker-dealer.*" (Emphasis added.)

Report and Recommendations of the Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231, 92d Cong., 2d Sess. 24 (1971).

In passing the Exchange Act, Congress recognized the vulnerable position of the vast majority of customers who must entrust their securities and cash to broker-dealers in order to participate in the securities markets, but who do not possess the sophistication to protect themselves from loss caused by the inadequate capitalization of a broker or dealer. *See* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3 (1934). The battery of net capital, "financial responsibil-

ity" and customer segregation rules, all of which are mandated by statute and to the functioning of all of which Rule 17a-5 is crucial, is intended to assure that broker-dealers will be able to meet their obligations to customers on demand. *See, e.g.,* E. Weiss, *Registration and Regulation of Brokers and Dealers,* 57-68 (1965); Report and Recommendations of the Securities and Exchange Commission, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231, 92d Cong., 2d Sess. 49-122 (1971); Study of the Securities Industry, Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 92d Cong. 1st Sess., Part 2, 782-89 (1971). The point of these rules is to protect even the most naive customers against loss suffered because of the financial condition of a particular broker. *Cf. Aldrich* v. *Redington, (In re Weis Securities, Inc.),* [1977-78 Transfer Binder] Bankr. L. Rep. (CCH) ¶ 66,884 (2d Cir. 1978), *cert denied sub nom., Grossmann* v. *Redington,* No. 78-746 (Jan. 22, 1979).

It is clearly appropriate to imply a right of action under Section 17 and the rules and regulations thereunder for customers and those who represent their interests—the class of persons "for whose especial benefit the statute was enacted." *Cort* v. *Ash,* 422 U.S. 66, 78 (1975), *quoting Texas & Pacific Ry.* v. *Rigsby,* 241 U.S. 33, 39 (1916); *J. I. Case Co.* v. *Borak, supra,* 377 U.S. at 432; *see Piper* v. *Chris-Craft Industries, Inc.,* 430 U.S. 1, 26-35 (1977). Such an action is necessary under Rule 17a-5 because it is the accountant's false certificate that prevents regulators from putting the system for safeguarding customer property into effect in time to avoid loss.

C. A Right of Action On Behalf Of Customers Is Essential To Achieve Section 17's Goals Of Protecting Customers.

As the Court of Appeals concluded, a right of action is indispensable to effective implementation of the purposes

of Section 17 and the entire statutory system of regulating broker-dealers for protection of customers. Such a right of action is also indispensable if customers are to have any effective recourse when accountants fail to perform the duties required by Rule 17a-5. State court remedies are non-existent or inadequate to protect customers, and (as the Weis experience demonstrates) the protection provided by administrative enforcement mechanisms is likely to come too little and too late to prevent loss to customers when the accountants relied on by regulatory authorities fail to perform their Rule 17a-5 duties.

The argument that customers should look to state court remedies for accountants' malpractice is an insufficient answer. Customers are likely to find that they have no such remedies. Exchange Act provisions and rules are no concern of the state courts, and state law regarding accountant's liability is dependent on rules of privity and procedural nuances which have nothing to do with the nature of the brokerage industry and the principles underlying federal regulation of that industry.[9] Even in those states which have retreated somewhat from the application of inflexible privity rules, the extent to which those rules have been relaxed (*i.e.,* to permit liability to specifically identifiable persons but not to a reasonably foreseeable class of persons such as customers)[10] and the theory on

9. For recent cases on state law following the rules of strict privity in *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441 (1931), *see, e.g., Stephens Industries, Inc.* v. *Haskins and Sells,* 438 F.2d 357 (10th Cir. 1971) (Colorado law); *Nortek, Inc.* v. *Alexander Grant & Co.,* 532 F.2d 1013 (5th Cir. 1976) (Florida law); *Howard* v. *Dun & Bradstreet, Inc.,* 136 Ga. App. 221, 220 S.E.2d 702 (Ct. App. 1975) (Georgia law); *Investment Corp. of Florida* v. *Buchman,* 208 So. 2d 291 (Fla. Dist. Ct. App. 1968) (Florida law).

10. *E.g., Arizona Title Insurance and Trust Co.* v. *O'Malley Lumber Co.,* 14 Ariz. App. 486, 493, 484 P.2d 639, 646 (Ariz. Ct. App.

which such relaxation has been based (*i.e.*, consideration of case-by-case factors which have no connection with the purposes of Rule 17a-5),[11] provide no confidence that customers of brokerage firms will find adequate protection in the state courts. In fact, if the right to relief in the federal courts were to be denied, the cruellest irony of all would be the exclusive jurisdiction provision contained in Section 27, a provision which Touche Ross has argued deprives customers of any ability to sue in the state courts for an accountant's breach of his Rule 17a-5 duties. (See *supra* at 14.)

That state remedies may be far less adequate than Touche Ross suggests in its brief to this Court is demonstrated by the position Touche Ross has taken on some of these same issues both in the District Court and in the state court action. Touche Ross' position in both courts has been that customers can state no claim for relief against Touche Ross under state law and that the Trustee can state a state law claim for relief only for negligence (and then only on behalf of Weis and not on behalf of Weis' customers). Touche Ross has also argued in both those courts that no claim can be stated under state law on any theory based on Touche Ross' failure to comply with Rule 17a-5. Thus, if no private right of action is implied for an accountant's failure to comply with Rule 17a-5, customers or their representatives in New York, and in many other states, may well find themselves without an effective remedy for losses incurred because of grossly defective accounting services.

1971); *Security National Bank* v. *Lish*, 311 A.2d 833 (D.C. 1973); *Ryan* v. *Kanne*, 170 N.W.2d 395, 403 (Iowa 1969); *Craig* v. *Everett M. Brooks Co.*, 351 Mass. 497, 501, 222 N.E.2d 752, 755 (Mass. 1967).

11. *E.g.*, *Aluma Kraft Manufacturing Co.* v. *Elmer Fox & Co.*, 493 S.W.2d 378, 383 (Mo. Ct. App. 1973); *Biakanja* v. *Irving*, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (Cal. 1958).

Moreover, the protection afforded customers in this regulated industry should not depend on whether a customer or his broker happens to reside in a state which is liberal or restrictive on matters of malpractice and negligence liability. Congress gave the federal district courts exclusive jurisdiction in Section 27 to eliminate the elements of doubt, uncertainty and randomness which would necessarily exist if enforcement of Exchange Act rules were left to the state courts. *Compare J. I. Case Co.* v. *Borak, supra,* 377 U.S. at 435, *with Cort* v. *Ash, supra,* 422 U.S. at 84-85. *See also Bivens* v. *Six Unknown Named Agents of Federal Bureau of Narcotics, supra,* 403 U.S. at 394-95.

Asking customers to rely on administrative enforcement is also no answer. As the Second Circuit found, a private action on behalf of customers is an "essential supplement" to the enforcement activities of the regulatory authorities. (A200.) The limited efficacy of administrative enforcement in securing Section 17's goals is an important reason for implying a private right of action for violations of Rule 17a-5. *See, e.g., J. I. Case Co.* v. *Borak, supra,* 377 U.S. at 432; *Allen* v. *State Board of Elections,* 393 U.S. 544, 556-57 (1969).

Audited financial reports under Rule 17a-5 have always been essential to ensuring customer protection. This is because accurate, audited year-end reports under the Rule provide the benchmark for all subsequent monitoring by the SEC, the Exchange and SIPC. As the Second Circuit pointed out (A199-200), the entire administrative enforcement and monitoring machinery falls apart when independent auditors fail to expose material weaknesses in a broker's financial condition. In its opinion the Second Circuit noted (A199 n.12) that because over 5,000 brokers and dealers are registered with the Commission, the Commission can examine independently the data set out in the

financial statements of only a small fraction of the nation's brokers and dealers. Auditors are engaged to make Rule 17a-5 audits because the SEC could not make this many detailed examinations itself without hiring an army of eye-shaded bureaucrats at intolerable social cost and staggering public expense.

In passing on an almost identical situation in *Borak* this Court expressed the relevant considerations:

> "Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements. The Commission advises that it examines over 2,000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value, unless contrary to other material on file with it. Indeed, on the allegations of respondent's complaint, the proxy material failed to disclose alleged unlawful market manipulation of the stock of ATC, and this unlawful manipulation would not have been apparent to the Commission until after the merger." (377 U.S. at 432-33.)

The theoretical availability of SEC injunctive actions, or of criminal proceedings, for violations of Rule 17a-5 falls short of securing the "protection of investors" for the same reasons identified in *Borak*. The instigation of these proceedings is dependent upon the receipt of warnings from independent accountants. The SEC and the stock exchanges cannot retrace the auditor's steps, and even if they could, weeks and months might pass before

crucial omissions were unearthed. When accountants fail to act, seldom, if ever, can action be taken in time to prevent harm to customer property. The Court below recognized that subsequent criminal convictions (such as those of the Weis five) cannot adequately protect customers. (A199-200.) Convictions punish some of the guilty and injunctions provide some protection for the future investors. But these steps provide no relief for the losses incurred to customers' property in the past because of the accountants' failure to conform to Rule 17a-5.

D. The Decisions Under Section 6 Of The Exchange Act, As Well As This Court's Decision In *Borak*, Support A Right Of Action Under Section 17.

The existence of a private right of action under Section 17 is also supported by the policies which for thirty-five years have supported a right of action for customers against securities exchanges under Section 6 of the Exchange Act, and which led this Court to imply a private right of action under Section 14(a) in *Borak*. *See, e.g., Baird* v. *Franklin,* 141 F.2d 238, 244-45 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944); *Lank* v. *New York Stock Exchange,* 548 F.2d 61, 64-66 (2d Cir. 1977); *Arneil* v. *Ramsey,* 550 F.2d 774, 783 (2d Cir. 1977); *Butterman* v. *Walston & Co.,* 387 F.2d 822, 824-25 (7th Cir. 1967), *cert. denied,* 391 U.S. 913 (1968).

A private right of action under Section 6 was first upheld by the Second Circuit in *Baird* v. *Franklin, supra,* on behalf of an investor who alleged that a member firm of the Exchange had unlawfully converted his securities and that his injuries were caused by the Exchange's failure to enforce its rules and take disciplinary action against the firm. The panel which decided the case was a distinguished one, consisting of Judges Swan, Augustus Hand, and then Circuit Judge Clark. The court's rationale in

upholding the right to sue under Section 6 was written by Judge Clark. After identifying the purpose of Section 6(b) as "the protection of investors" (141 F.2d at 244), Judge Clark reasoned, in language that is particularly relevant here, that:

> "If these aims are to be followed by the Act, then, if the investing public is to be completely and effectively protected, § 6(b) must be construed as granting to injured investors individual causes of action to enforce the statutory duties imposed upon the exchanges. The only two sections of the Act which impose express sanctions upon an exchange for violations are §§ 19 and 32, 15 U.S.C.A. §§ 78s, 78ff. The former permits, § 19(a)(1), the withdrawal of the registration of an exchange for a period not to exceed twelve months or the suspension for a similar period of any member or officer, § 19(a)(3); the latter prescribes a fine of not more than $500,000. Neither section, however, can be said to inure at all to the benefit of the defrauded investor, whom the statute professes to protect reasonably effectively and completely. Both are punitive and remedial measures, rather than compensatory; and while they may be of benefit to future investors, they do nothing for those who have already been the victims of overreachings.
>
> * * * If § 6(b) here were to be construed as granting no right of action to plaintiffs, the avowed purpose of 'reasonably complete and effective' protection would indeed be a snare and a delusion.
>
> The fact that the statute provides no machinery or procedure by which the individual right of action can proceed is immaterial. It is well established that members of a class for whose protection a statutory duty is created may sue for injuries resulting from its breach and that the common law will supply a remedy if the statute gives none." (141 F.2d at 244-45.)

The principles that permit a broker's customers to sue a stock exchange for failing to fulfill its statutory obligations to monitor and discipline the broker should permit an action in the interest of customers against another third party actor, the accountant, for failing to perform in accordance with the duties it assumes to audit and report under Rule 17a-5. Section 6 and Section 17 are two integral pieces of the same statutory scheme for regulating broker-dealers for the benefit of customers. There is no way of preventing loss to customer property other than compensatory damage actions if the accountants who are paid to perform a key role in the statutory scheme fail to perform that role in accordance with the statute and the rule.

The principles and policies which justify finding a private right of action under Sections 17 and 27 all coalesced in this Court's decision in *Borak*. In that case this Court considered the issue of "whether § 27 of the [Exchange] Act authorizes a federal cause of action for rescission or damages to a corporate stockholder" arising from misleading proxy materials violative of Section 14(a). (377 U.S. at 428.) The Court unanimously concluded that it did, and in so holding emphasized precisely the same considerations which are at play under Section 17: (1) the language of Section 14 which, like Section 17, evinced broad remedial purposes "for the protection of investors," (*id.* at 431-32); (2) the "clear" authorization in Section 27 for private parties to bring suit for violation of Section 14(a) (*id.* at 430-31, 433); (3) the need for private enforcement as a necessary adjunct to action by the SEC because of the Commission's limited oversight capability in the area (*id.* at 432-33); and (4) the fact that state court remedies were inadequate and fraught with unnecessary and often insur-

mountable hurdles to relief. (*Id.* at 434-35.) The Court held that:

> "while this language [of Section 14(a)] makes no special reference to a private right of action, among its chief purposes is 'the protection of investors,' which certainly implies the availability of judicial relief where necessary to achieve that result." (377 U.S. at 432.)

The *Baird* and *Borak* decisions could not be more on point. The analysis in *Borak*, frequently cited with approval by this Court,[12] and the rationale uniformly adopted in the federal courts to imply a private right of action against self-regulatory bodies under Section 6, apply to the rights of customers against accounting firms under Section 17 and Rule 17a-5.

Accountants are or should be aware of their role in the regulatory scheme and of the implicit reliance placed upon their work by customers when they undertake to conduct Rule 17a-5 audits. They must be held responsible under Section 17 when customers are injured by their failure to comply with SEC rules and detect fraud in time to avert a brokerage house collapse.

12. Touche Ross invites (T.R. Br. at 68 n.41) this Court to state "unequivocally" that *Borak's* viability as a precedent has been eroded by subsequent decisions. As noted in the concurring opinion below (A206 & n.1), however, the decision and rationale in *Borak* have consistently been reaffirmed, and its application to situations comparable to that presented by Rule 17a-5 has never been questioned by this Court. *See, e.g., Piper* v. *Chris-Craft, Industries, Inc.*, 430 U.S. 1, 25 (1977); *Rondeau* v. *Mosinee Paper Corp.*, 422 U.S. 49, 62 (1975); *SIPC* v. *Barbour*, 421 U.S. 412, 423-24 (1975); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 730 (1975); *Wyandotte Transportation Co.* v. *United States*, 389 U.S. 191, 202 (1967).

II.

THERE ARE NO PERSUASIVE ARGUMENTS AGAINST RECOGNIZING A PRIVATE RIGHT OF ACTION UNDER SECTION 17.

A. Section 18 Is Not Pertinent To Section 17.

The linchpin of the argument against implying a right of action under Section 17 is that Section 18(a) of the Exchange Act provides the exclusive remedy that any class of persons may have for violations of Section 17. (T.R. Br. at 33-40.) This argument is based on bits and pieces of language from various cases in this Court which are asserted to be "controlling". (T.R. Br. at 40-46.) Touche Ross virtually concedes that, if Section 18 is not regarded as an intentional limitation on the right of customers to sue for violations of Section 17, the considerations for implying private rights of action under *Borak, Texas & Pacific Ry.* v. *Rigsby* and *Cort* v. *Ash* would be satisfied.

The position that Section 18 applies to Section 17, in effect, mixes apples and oranges, for those sections address different and separable classes of persons and interests. The purpose of Section 18 is to define the elements of a cause of action for a specific class of persons who are protected by the anti-fraud provisions of the Exchange Act. These persons are investors in their capacity *as traders* in the stock of listed corporations which file reports with the SEC. Section 18 confers rights on those trading in the stock of a particular corporation who have suffered injury because the price of the stock traded was affected by a misleading statement; it provides remedies to investors *as traders* only when they have purchased or sold a particular issuer's securities. Under the *expressio unius* principle, Section 18 prevents investors *as traders* in a particular security from suing other than when they have made a purchase or sale.

Section 17, on the other hand, is directed at protecting a different class of persons and interests. As set forth in greater detail above (*supra* at 5-6, 28-30), it is aimed at protecting customers of broker-dealers; it protects investors not in their capacity as purchasers or sellers of a particular issuer's securities but rather in their capacity *as customers* who must entrust their cash or securities to broker-dealers. Section 17 addresses a class of persons and interests for whom the imposition of a threshold purchaser-seller requirement like that contained in Section 18(a) would be an inappropriate and artificial limitation, having nothing to do with the purposes for which Section 17 and Rule 17a-5 were promulgated.

Investors *as customers* do not purchase or sell a brokerage firm's publicly traded securities in reliance on Rule 17a-5 certifications and the monitoring system of which they are a part; investors *as customers* simply entrust their money and securities to a specific brokerage firm on the congressionally sanctioned assumption that it is adequately capitalized and regulated. As Judge Lumbard noted below (A200), even the most egregious errors committed by an accountant performing a Rule 17a-5 audit would not in any way affect the price of securities traded by a broker's customers. Yet such errors might well lead to loss of the property entrusted to the broker by the customer. Were Section 18 to be applied to define the limits of causes of action for violations of Rule 17a-5, it would lead to the anamolous result that a statute enacted for the express purpose of protecting a particular class of persons in fact provided no protection whatsoever to that class. That sort of intent should not lightly be imputed to the Congress.[13]

13. The Second Circuit noted below (A198) that the legislative history of Section 17 was silent with respect to congressional intent regarding a private right of action. Touche Ross also can point to no explicit consideration of the issue (T.R. Br. at 46-47). In its *amicus* brief, the American Institute of Certified Public Accountants relies on an excerpt from the Congressional Record to support its argument that Congress intended the purchaser-seller limitation of 18(a) to apply to any action involving any reports filed with the SEC. (Amicus Br. at 9-11.) The remarks relied on provide no such support. The focus of those remarks was solely the burden of proof required in cases involving the purchase or sale of securities based on misleading statements. To the extent that some congressional intent on the scope of Section 18(a) may be divined from those remarks, it appears to support the view that Section 18(a) does not apply to Section 17. The rationale for Speaker Rayburn's position that the disseminator of misleading information should be held liable even absent actual knowledge of falsity was that he would be unjustly enriched in the sales transaction with the investor. The remarks directly following those quoted in the *amicus* brief make this clear:

> "Mr. Hollister: Exactly, and it may have been a lawyer or an accountant or any other expert hired for the occasion. We make such a man practically an insurer, no matter how honest he may have been, if the statement is misleading. If he cannot sustain the burden of proof he is going to be held liable.
>
> Mr. Rayburn: Exactly, because he got the other man's money."

78 Cong. Rec. 8040 (1934). *See also id.* at 8039. Such a rationale obviously has no applicability to accountants who make certifications under Rule 17a-5.

Touche Ross' attempt to superimpose Section 18 on Section 17, and its invocation of the *expressio unius est exclusio alterius* doctrine (T.R. Br. at 41-43) and the principle that a right of action should not be implied where a narrower express remedy exists for the same wrong (T.R. Br. at 43-45), consequently miss the mark. It would be an extraordinary result, mandated by no prior decision of this Court, to divine from a provision defining the rights of one class of persons protected by one set of Exchange Act provisions an intent to deny a right of action to a different class of persons—customers of brokerage firms *in their capacity as customers*—protected by different provisions of the Exchange Act. Section 18(a) has never before been read to forbid damage actions under Section 27 by persons

such as customers who are protected by a set of provisions different from those aimed at protecting traders in a particular issuer's security against fraud and misinformation. *See, e.g., J. I. Case Co.* v. *Borak,* 377 U.S. 426 (1964); *Gerstle* v. *Gamble-Skogmo, Inc.,* 478 F.2d 1281 (2d Cir. 1973); *Baird* v. *Franklin,* 141 F.2d 238 (2d Cir.), *cert. denied,* 323 U.S. 737 (1944).[14] This Court's decisions under Rule 10b-5 and the Williams Act have never suggested that Section 18 is the exclusive remedy for Exchange Act violations even where, as in *Piper* v. *Chris-Craft Industries, Inc.,* 430 U.S. 1 (1977), the filing of a "report" or "document" was involved. See *supra* at 21.

The situations involved in *National Railroad Passenger Corp.* v. *National Association of Railroad Passengers,* 414 U.S. 453 (1974) (*"Amtrak"*) and *SIPC* v. *Barbour,* 421 U.S. 412 (1975) were not comparable to the Section 17-Section 18 dichotomy in the Exchange Act. *Amtrak* and *Barbour* involved situations where private parties sought to intrude into areas where the right to injunctive or similar relief had been entrusted to a government entity or the attorney general, and where the private party was suing either to force that entity to act or, in effect, to reverse that entity's

14. Touche Ross points to a number of cases which have suggested that Section 18 provides the exclusive remedy for violations of Section 13(a) of the Exchange Act. (T.R. Br. at 51-54.) Section 13(a) requires issuers of securities to file certain required information with the SEC "for the proper protection of investors and to insure fair dealing in the security." Section 13 was designed to protect investors trading in a corporate issuer's securities from misleading statements by the issuer relating to its financial condition. *See* S. Rep. No. 792, 73d Cong., 2d Sess. 11 (1934). As the language and purpose of Section 13 itself make evident, the cases relied upon by Touche Ross cannot assist in the resolution of the issue herein. At best, they stand for nothing more than that the remedy and limits set forth in Section 18 should apply to all members of the same class of investors to which Section 18 itself is addressed—the traders in securities, the price of which may have been affected by the issuer's fraud. Sections 13 and 18 are both integral parts of the Exchange Act's anti-fraud provisions. Section 13 does not concern customers—the class of persons protected by Section 17.

decision. In both cases implying a private right of action on behalf of one member of the class benefited by the statute would have conflicted with the interests of other members of the class and therefore would have contravened the congressional purpose in committing the balancing of interests to the discretion of a public official; in neither case did the statute in question contain a grant of jurisdiction comparable to that in Section 27 of the Exchange Act.

In *Amtrak* a railroad passenger organization brought suit under Section 307 of the Rail Passenger Service Act of 1970, 45 U.S.C. §§ 501 *et seq.,* to enjoin the discontinuance of certain passenger trains by the National Railroad Passenger Corp. (Amtrak). Section 307 narrowly provided for enforcement of the Act's duties by the Attorney General and, solely in the case of labor disputes, by aggrieved employees. (414 U.S. at 456-57.) The Act's purpose was to ensure the expeditious discontinuance by Amtrak of uneconomic railroad routes. Suits for injunctive relief by individuals across the country who felt aggrieved by the abandonment of particular routes would have frustrated the very purpose of the Act and would have been antagonistic to the interests of individuals in other parts of the country. (*Id.* at 463-64.) The Court therefore held that Section 307—the sole jurisdictional provision in the Act—created a right of action only in the parties enumerated therein. (*Id.* at 464-65.) In reaching its conclusion the Court eschewed exclusive reliance on the *expressio unius* doctrine and focused also on the legislative history which it found to be consonant with the limitations set forth in Section 307 (*id.* at 458-62) as well as with its determination that conferring a right of action on private parties with conflicting interests would be incompatible with the "efficient apparatus" set up by the statute to achieve its goals. (*Id.* at 463-64.)

The issue in *Barbour* was whether private parties had a right to compel SIPC to act to initiate liquidation proceedings under the 1970 Act. In denying the existence of such a right this Court focused on the fact that Congress had under the 1970 Act, as under the Amtrak Act, created a supervised corporate entity to solve a public problem (421 U.S. at 420); the Court again emphasized that delegating a right of action to private parties would have been totally at odds with the statutory scheme and purposes. (*Id.* at 421-23.) The Court was especially concerned about the grave risks to brokers (and of course their many other customers) if individual customers, without any attempt to seek less drastic solutions, were permitted to institute actions seeking compulsory liquidation predicated on allegations of the broker's financial insecurity. (*Id.* at 422-23.) For this reason Congress had committed the decision whether to liquidate a broker exclusively to SIPC and the SEC. The Court's distinction of the Exchange Act and its discussion of *Amtrak* is especially instructive here:

> "Unlike the Securities Exchange Act, the SIPA contains no standards of conduct that a private action could help to enforce, and it contains no general grant of jurisdiction to the district courts. As in *Amtrak*, a private right of action under the SIPA would be consistent neither with the legislative intent, nor with the effectuation of the purposes it is intended to serve." (*Id.* at 424.)

This case is clearly distinguishable from *Amtrak* and *Barbour*. No balancing of competing interests or consideration of discretionary factors is involved. This is a straightforward damage action based on violations of specific rules, an action involving issues of a sort which courts and juries are quintessentially well equipped to handle. The existence of such an action would benefit all customers and

thus would clearly effectuate rather than contravene the statutory purposes; indeed, a damage action for the losses to customer property which regulatory authorities are unable to prevent because of a defective audit was found below to be an "essential supplement" to the statutory scheme. (A200.) *See SIPC* v. ***Barbour, supra,*** 421 U.S. at 423-24 (carefully distinguishing *Borak*); 31 Vand. L. Rev. 1513, 1527-28 (1978).

Touche Ross' reliance on *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723 (1975), is also misconceived. *Blue Chip Stamps* only involved the question whether a particular class of persons—offerees of an allegedly misleading stock offering who neither purchased nor sold any of the offered shares—could sue for damages under Rule 10b-5. The Court held that they could not. The Court never questioned the principle that a private right of action could exist on behalf of the intended beneficiaries of a statute and, indeed, reaffirmed that such an implied right of action existed to enforce Rule 10b-5. (*Id.* at 730.)

In limiting the class of plaintiffs who could sue under 10b-5 in ***Blue Chip Stamps*** the Court relied in part upon what it termed "policy considerations." The Court was concerned that absent enforcement of the purchaser-seller requirement (1) strike suits under 10b-5 would become more prevalent (*id.* at 740), (2) the resolution of litigation would depend too heavily on the unrebuttable and unreliable oral testimony of plaintiffs as to what they would have done rather than on objectively demonstrable evidence (*id.* at 743-47), and (3) there would exist a potentially indeterminate number of plaintiffs whose prospective damage claims would be highly speculative. (*Id.* at 745-48.) Focusing on these considerations, Touche Ross argues (T.R. Br. at 48) that a private right of action should be denied in this case because the Section 17 claims asserted are "exactly the kind of speculative and unreliable claims that *Blue Chip Stamps* held are, and should be, excluded by the purchaser-seller requirement."

Touche Ross' argument plainly overstates the case. While the considerations relied upon by the Court in *Blue Chip Stamps* had relevance to the situation presented there, this action involves plaintiffs and claims at the farthest antipodes from those which troubled this Court in *Blue Chip Stamps*. The plaintiffs here—a court-appointed Trustee and a governmental corporation—are not likely to bring strike suits against accountants in the hope of securing unjustified, *in terrorem* settlements. See also *infra* at 49-50. This action, for example, is not based on speculation. It is based on a lengthy investigation of Weis' demise and Touche Ross' work papers, an investigation conducted with all the tools available to trustees under SIPA and the Bankruptcy Act.

The claims involved in this action are asserted on behalf of a *determinant* number of customers who entrusted a *determinant* amount of property to the debtor, and whose representative is now suing under Section 17 for a *determinant* amount of damages. These claims are based on objective evidence relating to customers' accounts contained in the debtor's books and records and not on potentially unreliable and unrebuttable oral testimony.

The accountants suggest that individual customers may create undesirable complexities by suing for additional or incidental items of damage resulting from delay in return of property or receipt of cash instead of securities in SIPA liquidations. But no such claims are presently before the Court. The recent amendments to SIPA, which are intended to permit all customers' property to be returned to them promptly and intact, make it unlikely that such claims will arise with any frequency in the future. See *infra* at 48-49. In any event it will be occasion enough for the judiciary to consider *Blue Chip Stamps* and the possible restrictions which might be placed on incidental damage

claims when, as and if those claims actually arise. Neither the facts nor the rationale of *Blue Chip Stamps* properly applies to the limited right of action recognized for SIPC and the Trustee by the Court of Appeals.

B. The Miscellaneous Policy Considerations Adverted To By Touche Ross Are Of No Moment.

Touche Ross also raises several policy considerations which it asserts militate against a Section 17 right of action. These considerations are primarily that accountants will become unwilling "insurers" subject to limitless suits by an indeterminate class of persons, and that the federal courts will be overwhelmed by litigation. (T.R. Br. at 71-78.)

Before addressing these assertions in greater detail it must be recognized at the outset that, if policy considerations are relevant to resolving the question of a right of action under Section 17, then the principal policy to be considered is protection of public investors. This is the purpose of the statute and rules. As set forth more fully above, absent private damage enforcement customers will have illusory protection and be subject to divergent, irrelevant and inadequate state rules. In view of the broad grant of jurisdiction in Section 27 for violation of Exchange Act duties, it is appropriate for the federal courts to fashion federal remedies for the protection of those for whose direct benefit the duties are imposed. *E.g., J. I. Case Co.* v. *Borak, supra,* 377 U.S. at 433; *Baird* v. *Franklin, supra,* 141 F.2d at 245. *See Rondeau* v. *Mosinee Paper Corp., supra,* 422 U.S. at 62-63.

Contrary to Touche Ross' argument (T.R. Br. at 73) that "the holding of the Court of Appeals majority necessarily is open-ended and has the potential for effecting an extreme expansion of the scope of civil liability under the 1934 Act," the prospective liability of accountants under Section 17

will arise only in exceptional circumstances and will likely be limited to a small group of persons. This is primarily because of recent amendments to the 1970 Act which provide increased levels of protection for customers as well as greater speed and flexibility in satisfying customer claims than existed under the original SIPA. *See* Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, 92 Stat. 249; H.R. Rep. No. 95-746, 95th Cong., 1st Sess. 37, 39-40 (1977).

Under the new SIPA, customer accounts are protected by SIPC for up to $40,000 in cash and up to $100,000 in cash and securities, instead of the $20,000 and $50,000 protection which existed under the 1970 Act. *Compare* 15 U.S.C. §§ 78fff(f)(1), (f)(1)(A), *with* Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, § 9 (§§ 9(a), 9(a)(1) as amended), 92 Stat. 265. In addition, in order to increase the satisfaction of customer claims by securities instead of cash, and in order to ensure that customer accounts are restored as closely as possible to their positions at the filing date, SIPA trustees now have power to purchase securities for customer accounts and to permit full securities positions to be returned to margin customers and others; and in order to accelerate the distribution of securities to customers and reduce losses caused by delay in return of property, the new SIPA allows the Trustee to transfer to other brokers (who are members of SIPC) all or part of a customer's account. *See* Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, § 9, (§§ 8(c)(2), 8(d), 8(f) as amended), 92 Stat. 262-63, 265. The purpose and effect of these amendments is to make it extremely unlikely that customers will suffer appreciable loss in a brokerage house collapse and to eliminate to a large extent the kind of miscellaneous damage claims which Touche Ross suggests (T.R. Br. at 76-77) might be asserted against accountants even when customers' claims for cash and securities have been satisfied by the new monetary limits. *See* H.R. Rep. No. 95-746, 95th Cong., 1st Sess. 21-22, 39-42 (1977). Thus, all that is really involved here is the possibility of a small number of damage claims being filed in the future by SIPC, and perhaps in rare cases by a SIPA trustee, in the extraordinary liquidation in which the size of monetary loss to customer property and the nature of the accountant's conduct appear to make such an action worthwhile.

Touche Ross' statistics on broker liquidations and the number of customers who have participated in SIPA proceedings in the eight years since SIPA was enacted (T.R. Br. at 75) also exaggerate what the future is likely to hold in store in terms of potential Section 17 litigation, whether against accountants or others. Only a handful of the liquidations referred to by Touche Ross have occurred since 1973, and the amount of losses sustained by customers or even by SIPC in these post-1973 liquidations has not been substantial. *See* H.R. Rep. No. 95-746, 95th Cong., 1st Sess. 37, 38 (1977). As noted in the Senate Report of the SIPA amendments:

> "There have been 129 liquidation proceedings under SIPA since 1970, the great majority of those liquidations commenced in 1973 and earlier years. Because of better surveillance and other factors, the number of liquidations has been declining since that time." S. Rep. No. 95-763, 95th Cong., 2d Sess. 2 (1978).[15]

15. Under the 1970 Act, the total number of customers whose claims were not satisfied in full (and whose claims could therefore conceivably have led to a Section 17 suit against anyone, either by a SIPA trustee or an individual claimant) in 124 liquidations, including Weis, between 1970 and the first six months of 1977, was 163, and their claims totaled only $3 million. H. R. Rep. No. 95-746, 95th Cong., 1st Sess. 21, 40. The Weis liquidation accounts for a substantial portion of both figures. Had the increased amounts of SIPC cash advances established by the SIPA amendments been in effect, the number of customers with unsatisfied claims would have been reduced to 21, and their claims would have totaled $2 million. *Id.* at 40.

The fear that, regardless of fault, accountants will become scapegoats for breakdowns that occur in the regulatory scheme is unfounded. SIPC and SIPA trustees are the most likely, if not the only, possible plaintiffs under the new SIPA. These entities are accountable to the Congress and the courts respectively and are not going to embark on witch-hunts for accountants. If a Section 17 right of action is sustained, accountants will face liability only in the following exceptional circumstances: first, a major brokerage house must fail and be placed in liquidation; second, the accountant must have breached its obligations under Section 17 to the customers of the brokerage house in a manner so egregious that effective remedial action becomes impossible (for example, as here, where Touche Ross is alleged to have failed to detect crude bookkeeping manipulations and acts of fraud and criminal conduct); and finally, the collapse of the brokerage house must be so complete that even under the new SIPA, customer claims cannot be satisfied from property marshalled in the course of the liquidation. This unhappy conjunction of circumstances is not an everyday event.[16] It is the type of event for participation in which an accountant ought to be held accountable if he is at fault.

16. Weis, for example, is the only member of the New York Stock Exchange ever to be liquidated under the 1970 Act. One hundred twenty-eight SIPA liquidations other than this one have taken place; they have apparently produced no actions under Section 17. The customer actions that Touche Ross points to (T.R. Br. at 16 n.12) are all suits arising out of this liquidation. These circumstances underscore the limited potential liability of accountants under Section 17.

Of course, in those rare instances when accountants do fail to perform their Rule 17a-5 duties and customers suffer compensable damage in a liquidation, Sections 17 and 27 must be available to provide relief.

C. *Scienter* Is Not Required To Sustain A Right Of Action Under Section 17.

Relying on snatches of this Court's decision in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976) Touche Ross takes the fall back position that *scienter* must be an element of the Trustee's right of action under Section 17. (T.R. Br. at 80-83.)

The issue of *scienter* was not addressed by either the District Court or the Court of Appeals and should not be considered in the first instance by this Court. Moreover, this question was not fairly comprised, or even suggested, in the questions presented in the petition for certiorari. *Cort* v. *Ash, supra,* 422 U.S. at 72-74 n.6, *quoting Neely* v. *Eby Construction Co.,* 386 U.S. 317, 330 (1967).

If the Court does reach this issue, it would be erroneous to attempt to extrapolate from this Court's decision in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976) regarding Section 10b and Rule 10b-5 some sort of *scienter* requirement for Section 17. *Hochfelder* itself recognized that recklessness might be an appropriate standard even under a specific anti-fraud provision such as Rule 10b-5. (425 U.S. at 193-94 n.12.)

Unlike Section 10b and the rules and regulations thereunder, moreover, Section 17 and its rules and regulations are not anti-fraud provisions directed at schemes and artifices to defraud or cunning and manipulative devices. *Compare Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 471-77 (1977); *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 197-201. Section 17a-5 protects customers by imposing certain duties on accountants who undertake to audit a broker in accordance with the requirements of the Rule. An accountant need not have a specific intent to defraud in order to breach his duties under the Rule and impair the efficacy of the system established by Congress for protecting customers. Negligence, gross negligence and recklessness are alleged in the complaint, and any of

these standards of fault should suffice for imposition of Section 17 liability.

III.

THE TRUSTEE IS A REAL PARTY IN INTEREST TO SUE UNDER SECTION 17 FOR DAMAGES TO THE FUND OF CUSTOMER PROPERTY OF WHICH HE IS BAILEE.

The Second Circuit held that the Trustee could maintain this action on behalf of customers whose claims have not been satisfied in full out of the fund of customer property available to the Trustee in the Weis liquidation. (A203-04.) The Trustee was permitted to sue in this limited capacity as bailee of customers' property because of his special duties to marshal and return a fund of customer property separate and apart from Weis' own assets.[17] The Second Circuit's decision on this point was based on centuries-old principles of bailment law, the special duties of SIPA Trustees and the special nature of customer property, and should not be disturbed by this Court.

The key to understanding the Trustee's right to sue on behalf of customers under Section 17 is recognition that the Trustee's Section 17 claims are for damages to a specific and separate fund of customer property, not for damages to Weis as an entity or to any property deemed part of Weis' assets. The Trustee has not sought review of the portion of the Second Circuit's decision which denied him capacity to sue under Section 17 for damage done to the Weis general estate or to Weis as a going concern.

The scheme of remedies provided for customers by Congress in the 1970 Act (and previously in Section 60e of the

17. The Court of Appeals held that SIPC, as subrogee of customers whose claims were satisfied with SIPC cash advances, could sue to recover directly the portion of the deficit in the fund representing SIPC's claim against the fund for unreimbursed cash advances. (A201-02.) If this determination were to be reversed, the Trustee would be a proper plaintiff to sue for this portion of the deficit as well as that portion attributable to unsatisfied individual customer claims.

Bankruptcy Act as well as at present in the recent amendments to the 1970 Act) is predicated on the basic concept that customers never lose ownership of customer property, no matter how it may be registered, hypothecated or commingled in the broker's hands; the broker owes a special duty to safeguard that property (at least in the aggregate) and remain able to return it. The provisions of the 1970 Act, as well as Section 60e and the new SIPA, recognize the rights of customers as a group to the aggregate of customer property even when a specific customer cannot trace to a particular fund of cash or security. *See* Bankruptcy Act Section 60(e)(2), 11 U.S.C. § 96 (e)(2); 1970 Act §§ 6(c)(2)(B) and 6(c)(2)(C), 15 U.S.C. §§ 78fff(c)(2)(B), (c)(2)(C); Securities Investor Protection Act Amendments of 1978, Pub.L.No. 95-283, § 9, (§ 8(c) as amended), § 15, (§§ 16(4), (5) as amended), 92 Stat. 262-63, 272; 3 W. Collier, *Bankruptcy* ¶ 60.71 at 1158 (14th ed. 1976); H.R. Rep. No. 1409, 75th Cong., 1st Sess. 31 (1937).[18]

18. *See also, e.g.,* Section 8-313(2) of the New York Uniform Commercial Code which provides:

> "(2) The purchaser is the owner of a security held for him by his broker * * *. Where a security is part of a fungible bulk the purchaser is the owner of a proportionate property interest in the fungible bulk." (McKinney's 1964.)

The basic ownership concepts actually antedate all these legislative enactments. Prior to the 1970 Act and Section 60e of the Bankruptcy Act, when concepts of ownership originally developed for tangible property were applied in somewhat procrustean fashion to intangibles, customers of stockbrokers were considered the owners of stock held in the broker's own name under the majority or "New York" rule. Even in margin transactions, where the metaphysics of title seemed least clear, the customer was considered owner of the stock and the broker was considered but a pledgee—a classic type of bailment relationship. *E.g., Gorman* v. *Littlefield,* 229 U.S. 19 (1913); *Sexton* v. *Kessler & Co.,* 225 U.S. 90 (1912); *Richardson* v. *Shaw,* 209 U.S. 365 (1908); *Content* v. *Banner,* 184 N.Y. 121, 76 N.E. 913 (1906); *Markham* v. *Jaudon,* 41 N.Y. 235, 241 (1869). Under the minority or "Massachusetts" rule, the bankruptcy of the broker was deemed to vest title to the stock held by the broker in the

Under the 1970 Act applicable to the Weis liquidation, this principle of customer ownership was reflected in two categories of customer property—"specifically identifiable property" of cash customers and the "single and separate fund" of "customer property." Specifically identifiable property comprised fully paid for securities in customer name and fully paid for securities in street name allocated to cash customers. 1970 Act § 6(c)(2)(C), 15 U.S.C. § 78fff(c)(2)(C). All other property "at any time received, acquired, or held * * * from or for the account of customers", including securities equal to 140 percent of a margin customer's margin indebtedness to the broker and property commingled by the broker with its own property, was conceived of as part of the single and separate fund of customer property. 1970 Act § 6(c)(2)(B), 15 U.S.C. § 78fff (c)(2)(B).

Under the new SIPA, the equivalent of specifically identifiable property is "customer name securities"—a term defined to mean all securities registered or in the process of being registered in the name of a customer. All other property that was or should have been set aside for customers by the broker is termed simply "customer property". *See* Securities Investor Protection Act Amendments of 1978, Pub.L. No. 95-283, § 15, (§§ 16(4),(5) as amended), 92 Stat. 272.

Under both the new SIPA and the 1970 Act, the same concept obtains: the Trustee administers a fund of "customer property" which cannot be identified in kind but is nevertheless recognized as property owned by customers collectively. This fund of "customer property" is regarded as belonging to customers and not simply as having

customer, who could then obtain possession by paying any debit balance owing. In practice, therefore, the results were substantially the same as under the New York rule. *Leonard* v. *Hunt*, 36 F.2d 13, 15 (1st Cir. 1929). 3 W. Collier, *Bankruptcy* ¶ 60.72 at 1159-60 (14th ed. 1976); Note, *Protection of the Accounts of Stockbrokerage Customers*, 77 Harv. L. Rev. 1290, 1299 (1964).

become part of the broker's general assets in the same manner as, say, property purchased by a broker or cash loaned to it by general creditors.

While the broker is a functioning concern, its stewardship of large amounts of customer property subjects it to strict rules regarding hypothecation and segregation of securities and cash (SEC Rules 15c2-1, 15c3-3, 17 C.F.R. § 240.15c2-1, 15c3-3), and unique net capital rules designed to ensure that the broker will be reasonably able to meet its special obligations as custodian of customer property (SEC Rule 15c3-1, 17 C.F.R. § 240.15c3-1). *See* Guttman, *Broker-Dealer Bankruptcies*, 48 N.Y.U.L. Rev. 887, 893-903 (1973). When the broker is liquidated under the 1970 Act and a SIPA Trustee is appointed, the Trustee is under a duty to marshal both specifically identifiable property and the single and separate fund (or, under the new SIPA, customer name securities and customer property) and return this customer property to customers "as promptly as possible." 1970 Act § 6(a)(1), 15 U.S.C. § 78fff(a)(1); Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, § 8, (§ 6(a)(1) as amended), 92 Stat. 259. That is the primary purpose of a SIPA liquidation. The Trustee becomes the bailee of the customer property which had been entrusted to the broker by its customers.

As bailee, the Trustee has the right, under well-settled principles of bailment law, to sue third parties such as Touche Ross for any harm to, or diminution of, the fund of customer property caused by the acts or omissions of such third parties. With respect to this property, the Trustee is in a position no different from the owner-bailee of a furniture warehouse suing on behalf of the many owners of the furniture stored there. *See* Adv. Comm. Note to Fed. R. Civ. P. 17(a), 39 F.R.D. 69, 85.

The law is clear that a bailee, being entitled to the possession of the property bailed, has a special interest in

it which is sufficient to entitle him to sue third parties for a loss of or injury to the property:

> "For centuries it has been the settled rule, both at common law and in admiralty, that either the bailor * * * or the bailee * * * might sue the tort-feasor for destruction of the bailed goods." *The W. C. Block*, 71 F.2d 682, 683 (2d Cir.), *cert. denied*, 293 U.S. 579 (1934). (Citations omitted.)

Accord, e.g., The Beaconsfield, 158 U.S. 303, 307 (1895); *Luckenbach Steamship Co.* v. *United States*, 315 F.2d 598, 605 (2d Cir. 1963); *Bradley* v. *St. Louis Terminal Warehouse Co.*, 189 F.2d 818, 823 (8th Cir. 1951); *Rogers* v. *Atlantic, Gulf & Pacific Co.*, 213 N.Y. 246, 258, 107 N.E. 661, 664 (1915).

While it is true, as Touche Ross points out (T.R. Br. 86-91), that a bailee's right to sue is based on his special possessory interest in the property entrusted to him, that interest does not define the extent of the bailee's right to recover but merely reflects that it is his special possessory interest which makes a bailee an appropriate party in interest to prosecute an action for injury to the subject of the bailment. The courts have long recognized the right of bailees to represent and requite the interests of bailors as well as their own possessory interests.[19] In *The Beaconsfield*, 158 U.S. 303, 307 (1895), for example, this Court clearly indicated the representative capacity in which the bailee may sue on behalf of the bailor:

> "The Beaconsfield having been sunk in a collision with the Britannia, her master and owner, as bailees of her cargo, proceeded against the Britannia for damages done to such cargo. This they had a right to do. It is perfectly well settled that the carrier is so far the representative of the owner that he may sue in his own name, either at common law or in admiralty, for a trespass upon or injury to the property carried." (Emphasis added.)

19. In fact, originally the common law developed so that only the bailee—the party in possession—could enforce claims for injury to the bailed property. It was only later that the bailor was also allowed to vindicate his property interests. O. W. Holmes, *The Common Law*, 164 *et seq.* (1881); *Berger* v. *34th Street Garage, Inc.*, 274 App. Div. 414, 417, 84 N.Y.S.2d 348, 351 (1st Dep't 1948), *appeal denied*, 275 App. Div. 660, 86 N.Y.S.2d 667 (1st Dep't 1949).

Accord, Baldwin v. *Hill*, 315 F.2d 738, 742 (6th Cir. 1963) ("While it is true that a bailee does not have title to the bailed chattels, still he has a possessory interest in them. He may recover damages for injury done to the property and has other possessory rights. With respect to third persons, [a bailee] stands in the place of the owner [bailor]"); *Luckenbach Steamship Co.* v. *United States*, 315 F.2d 598, 605 (2d Cir. 1963); *Bradley* v. *St. Louis Terminal Warehouse Co.*, 189 F.2d 818, 823 (8th Cir. 1951).

As the Court of Appeals noted (A203-04), the representative character of the bailee-plaintiff is recognized in Rule 17(a) of the Federal Rules of Civil Procedure approved by this Court.[20] The Rule provides that a bailee or trustee may sue in his own name "without joining with him the party for whose benefit the action is brought." The Committee Note explaining the specific addition in 1966 of bailees to the list of those parties who could bring representative suits clearly recognized the representative capacity in which a bailee sues on behalf of the bailor:

> "The rule adds to the illustrative list of real parties in interest a bailee—meaning, of course, *a*

20. Rule 17(a) reads, in pertinent part, as follows:

> "Every action shall be prosecuted in the name of the real party in interest. An executor, administrator, guardian, *bailee*, trustee of an express trust, a party with whom or in whose name a contract has been made for the benefit of another, or a party authorized by statute may sue in his own name *without joining with him the party for whose benefit the action is brought.* * * *" (Emphasis added.)

> *bailee suing on behalf of the bailor* with respect to the property bailed. (When the possessor of property other than the owner sues for an invasion of the possessory interest he is the real party in interest.) The word "bailee" is added primarily to preserve the admiralty practice whereby the owner of a vessel as bailee of the cargo, or the master of the vessel as bailee of both vessel and cargo, sues for damage to either property interest or both. But there is no reason to limit such a provision to maritime situations. The owner of a warehouse in which household furniture is stored is equally entitled to sue on behalf of the numerous owners of the furniture stored." (Emphasis added.) 39 F.R.D. at 84-85.

The premise of Touche Ross' argument—that two separate and severable interests emanate from a bailment and that those interests prevent the bailee from suing as representative of the bailor rather than solely in his own interest as bailee—is also contradicted by three elementary principles of bailment law: (1) either the bailor or bailee can bring an action for the same injury to the bailed property, and a recovery by one is a bar to a subsequent recovery by the other; (2) a bailee can sue for a full recovery beyond the extent of its own direct harm and regardless of any pre-existing liability it might have to the bailor; and (3) the bailee holds such recovery in trust for the bailor. As the New York Court of Appeals explained in *Rogers* v. *Atlantic, Gulf & Pacific Co.*, 213 N.Y. 246, 258-259, 107 N.E. 661, 664 (1915):

> "A bailee, though not liable to the bailor, may recover for the wrongful act of a third party resulting in the loss of, or injury to, the subject of the bailment. * * * If the bailee recovers, he holds the recovery as trustee for the bailor. A recovery by either bailor or bailee will bar an action by the other."

Nothing in *Caplin* v. *Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), undercuts the propriety of the Trustee's assertion of claims as bailee to replenish the fund of customer property under Section 17. *Caplin* did not involve a SIPA Trustee with special duties to marshal and return to customers funds of "customer property" that are recognized as being separate from the debtor's own assets. In *Caplin*, no question of bailment law was presented. All *Caplin* held was that a Chapter X Trustee lacked standing to sue an indenture trustee for defaulting on its obligations to debenture holders. No one contended in *Caplin* that the corporate debtor (or its trustee) was a bailee of the money invested in the debtor by its debenture holders.[21]

Touche Ross' attempt to extrapolate from the rationale of *Caplin* an argument that granting standing to the Trustee would be inconsistent with the rights of customers and lead to a multiplicity of litigation (T.R. Br. at 98) also fails. In the first place, as discussed above, there is no reason to anticipate that many individual customers will have unsatisfied claims (or indeed any compensable damage) under the new SIPA; that statute is intended to ensure that unsatisfied claims become the rarest of exceptions, not the general rule. Second, in the exceptional cases where such claims may arise and be permitted by the courts, it is axiomatic under the law of bailment that

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21. The other two cases cited by Touche Ross in this section of its brief are also not in point because neither involved a SIPA Trustee's responsibilities to marshal and return customers' property to a broker-dealer's customers. *Lank* v. *New York Stock Exchange*, 548 F.2d 61 (2d Cir. 1977) involved a Delaware receiver, not a SIPA Trustee. Customer accounts had been transferred to other brokers. The broker's stewardship of customer's property was not involved in the decision; the receiver did not assert any claims as bailee for customers. *Miller* v. *New York Produce Exchange*, 550 F.2d 762 (2d Cir. 1977), involved only a bankruptcy trustee suing for damages to the bankrupt under the Bankruptcy Act; it, too, did not involve claims by the Trustee as bailee of customer property or the question of a trustee's capacity to sue for such claims.

any recovery by the Trustee as bailee would be held in trust for customers and would be binding *pro tanto* on the individual customer-bailors.[22] See ***supra at*** 58.

Not only is the Trustee an appropriate person to sue malefactors such as Touche Ross on behalf of fund claimants, but he is the most desirable plaintiff who could do so. As a result of his extensive pre-complaint investigation into the circumstances surrounding Touche Ross' role in the Weis *debacle,* the Trustee was (and a SIPA Trustee is likely always to be) in the best position to determine whether suit was justified in the first place, and is now (and a SIPA Trustee is likely always to be) in the best position to represent effectively the interests of all unsatisfied customers. If the goal of maximum customer protection under the Exchange Act is to have more than pious content, *someone* must be permitted to bring Section 17 actions to recover for loss to the fund of customer property caused by negligent, grossly negligent and reckless audits. As bailee of customer property, the Trustee is an appropriate plaintiff to pursue that action for customers.

22. The theoretical problem of multiplicity of lawsuits for the same loss to customer property might also be alleviated in future liquidations by use of assignments to the Trustee or SIPC of customers' rights, a possibility contemplated in SIPA. Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, § 9, (§ 8(b) as amended), 92 Stat. 262. *See SEC* v. *Albert & Maguire Securities Co.,* 560 F.2d 569, 573-74 (3d Cir. 1977).

Conclusion

For the foregoing reasons, as well as those set forth in SIPC's brief, the judgment of the Court of Appeals should in all respects be affirmed.

Respectfully submitted,

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APPENDIX

APPENDIX OF STATUTES

Securities Exchange Act of 1934

Section 27, 15 U.S.C. § 78aa:

Jurisdiction of Offenses and Suits

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district where in the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 225 and 347 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts.

Securities Investors Protection Act of 1970, as in effect prior to the Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, 92 Stat. 249 (1978)

Section 6(a)(1), 15 U.S.C. 78fff(a)(1):

(a) General purposes of liquidation proceeding.— The purposes of any proceeding in which a trustee has been appointed under section 78eee(b) (3) of this title

(hereafter in this section referred to as a "liquidation proceeding") shall be:

(1) as promptly as possible after such appointment and in accordance with the provisions of this section—

(A) to return specifically identifiable property to the customers of the debtor entitled thereto;

(B) to distribute the single and separate fund, and (in advance thereof or concurrently therewith) pay to customers moneys advanced by SIPC, as provided in subsection (f) of this section;

Section 6(c)(2)(B), 15 U.S.C. §78fff(c)(2)(B):

(B) Single and separate fund.—All property at any time received, acquired, or held by or for the account of a debtor from or for the account of customers except cash customers who are able to identify specifically their property in the manner prescribed in subparagraph (C), and the proceeds of all customers' property transferred by the debtor, including property unlawfully converted, shall constitute a single and separate fund; and all customers except such cash customers shall constitute a single and separate class of creditors, entitled to share ratably in such fund on the basis of their respective net equities as of the filing date and in priority to all other payments, except that (i) there shall be repaid to SIPC, in priority to all other claims payable from such single and separate fund, the amount of all advances made by SIPC to the trustee to permit the completion of open contractual commitments pursuant to subsection (d) of this section, and (ii) to the extent that any other assets of the debtor may be available therefor or as otherwise ordered by the court, all costs and expenses specified in clauses (1) and (2) of section 104(a) of Title 11 shall be paid from such single and separate fund in priority to the claims of such single and separate class of creditors, and any moneys advanced by SIPC for

such costs and expenses shall be recouped as such. If such single and separate fund shall not be sufficient to pay in full the claims of such single and separate class of creditors, the creditors of such class shall be entitled, to the extent only of their respective unpaid balances, to share in the general estate with general creditors. In, or for the purpose of, distributing such fund, all property other than cash shall be valued as of the close of business on the filing date. To the greatest extent considered practicable by the trustee, the trustee shall deliver in payment of claims of customers for their net equities based upon securities held on the filing date in their accounts (after giving effect to open contractual commitments completed as hereinafter provided), securities of the same class and series of an issuer ratably up to the respective amounts which were so held in such accounts. Any property remaining after the liquidation of a lien or pledge made by a debtor shall be apportioned between his general estate and the single and separate fund in the proportion in which the general property of the debtor and the property of his customers contributed to such lien or pledge.

Section 6(c)(2)(C), 15 U.S.C. § 78fff(c)(2)(C):

(C) Specifically identifiable property.—The trustee shall return specifically identifiable property to the customers of the debtor, entitled thereto. No cash or securities at any time received, acquired, or held by or for the account of a debtor from or for the accounts of customers shall for the purposes of this paragraph be deemed to be specifically identified, unless such property remained in its identical form in the debtor's possession until the filing date, or unless such property was allocated to or physically set aside for such customers on the filing date. In determining whether property was allocated to or physically set aside for such customers, it shall be sufficient that on the filing date:

(i) securities are segregated individually, or in bulk for customers collectively;

(ii) in the case of securities held for the account of the debtor as part of any central certificate service of any clearing corporation or any similar depositary--

(I) the records of the debtor show or there is otherwise established to the satisfaction of the trustee that all or a specified part of the securities held by such clearing corporation or other similar depositary are held for specified customers, or for customers collectively, and

(II) such records of the debtor also show or there is otherwise established to the satisfaction of the trustee the identities of the particular customers entitled to receive specified numbers or units of such securities so held for customers collectively; or

(iii) such property is held for the account of customers of the debtor in such other manner as the Commission, for the protection of customers and other creditors on a fair and equitable basis, by rule or regulation shall have determined to be sufficiently identifiable as the property of such customers.

If there is any shortage in securities of the same class and series of an issuer so segregated in bulk or otherwise held for customers pursuant to this subparagraph, as compared to the aggregate rights of particular customers to receive securities of such class and series, the respective interests of such customers in such securities of such class and series shall be prorated, without prejudice, however, to the satisfaction of any claim for deficiencies as otherwise provided in this section.

Securities Investor Protection Act Amendments of 1978, Pub. L. No. 95-283, 92 Stat. 249 (1978)

Section 9, (§ 8(b) as amended), 92 Stat. 262:

(b) PAYMENTS TO CUSTOMERS.—After receipt of a written statement of claim pursuant to subsection

(a)(2), the trustee shall promptly discharge, in accordance with the provisions of this section, all obligations of the debtor to a customer relating to, or net equity claims based upon, securities or cash, by the delivery of securities or the making of payments to or for the account of such customer (subject to the provisions of subsection (d) and section 9(a)) insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee. For purposes of distributing securities to customers, all securities shall be valued as of the close of business on the filing date. For purposes of this subsection, the court shall, among other things—

(1) with respect to net equity claims, authorize the trustee to satisfy claims out of moneys made available to the trustee by SIPC notwithstanding the fact that there has not been any showing or determination that there are sufficient funds of the debtor available to satisfy such claims; and

(2) with respect to claims relating to, or net equities based upon, securities of a class and series of an issuer which are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee, authorize the trustee to deliver securities of such class and series if and to the extent available to satisfy such claims in whole or in part, with partial deliveries to be made pro rata to the greatest extent considered practicable by the trustee.

Any payment or delivery of property pursuant to this subsection may be conditioned upon the trustee requiring claimants to execute, in a form to be determined by the trustee, appropriate receipts, supporting affidavits, releases, and assignments, but shall be without prejudice to any right of a claimant to file formal proof of claim within the period specified in subsection (a)(3) for any balance of securities or cash to which such claimant considers himself entitled.

Section 9, (§ 8(c) as amended), 92 Stat. 262-63:

(c) CUSTOMER RELATED PROPERTY.—

(1) ALLOCATION OF CUSTOMER PROPERTY.—The trustee shall allocate customer property of the debtor as follows:

(A) first, to SIPC in repayment of advances made by SIPC pursuant to section 9(c)(1), to the extent such advances recovered securities which were apportioned to customer property pursuant to section 6(d);

(B) second, to customers of such debtor, who shall share ratably in such customer property on the basis and to the extent of their respective equities;

(C) third, to SIPC as subrogee for the claims of customers;

(D) fourth, to SIPC in repayment of advances made by SIPC pursuant to section 9(c) (2).

Any customer property remaining after allocation in accordance with this paragraph shall become part of the general estate of the debtor. To the extent customer property and SIPC advances pursuant to section 9(a) are not sufficient to pay or otherwise satisfy in full the net equity claims of customers, such customers shall be entitled, to the extent only of their respective unsatisfied net equities, to participate in the general estate as unsecured creditors. For purposes of allocating customer property under this paragraph, securities to be delivered in payment of net equity claims for securities of the same class and series of an issuer shall be valued as of the close of business on the filing date.

(2) DELIVERY OF CUSTOMERS NAME SECURITIES.—The trustee shall deliver customer name securities to or on behalf of a customer of the debtor entitled

thereto if the customer is not indebted to the debtor. If the customer is so indebted, such customer may, with the approval of the trustee, reclaim customer name securities upon payment to the trustee, within such period of time as the trustee determines, of all indebtedness of such customer to the debtor.

(3) RECOVERY OF TRANSFERS.—Whenever customer property is not sufficient to pay in full the claims set forth in subparagraphs (A) through (D) of paragraph (1), the trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of the Bankruptcy Act. Such recovered property shall be treated as customer property. For purposes of such recovery, the property so transferred shall be deemed to have been the property of the debtor and, if such transfer was made to a customer or for his benefit, such customer shall be deemed to have been a creditor, the laws of any State to the contrary notwithstanding.

Section 9, (§ 8(d) as amended), 92 Stat. 263:

(d) PURCHASE OF SECURITIES.—The trustee shall, to the extent that securities can be purchased in a fair and orderly market, purchase securities as necessary for the delivery of securities to customers in satisfaction of their claims for net equities based on securities under section 7(b)(1) and for the transfer of customer accounts under subsection (f), in order to restore the accounts of such customers as of the filing date. To the extent consistent with subsection (c), customer property and moneys advanced by SIPC may be used by the trustee to pay for securities so purchased. Moneys advanced by SIPC for each account of a separate customer may not be used to purchase securities to the extent that the aggregate value of such securities on the filing date exceeded the amount permitted to be advanced by SIPC under the provisions of section 9(a).

Section 9, (§ 8(f) as amended), 92 Stat. 265:

(f) TRANSFER OF CUSTOMER ACCOUNTS.—In order to facilitate the prompt satisfaction of customer claims and the orderly liquidation of the debtor, the trustee may, pursuant to terms satisfactory to him and subject to the prior approval of SIPC, sell or otherwise transfer to another member of SIPC, without consent of any customer, all or any part of the account of a customer of the debtor. In connection with any such sale or transfer to another member of SIPC and subject to the prior approval of SIPC, the trustee may—

(1) waive or modify the need to file a written statement of claim pursuant to subsection (a)(2); and

(2) enter into such agreements as the trustee considers appropriate under the circumstances to indemnify any such member of SIPC against shortages of cash or securities in the customer accounts sold or transferred.

The funds of SIPC may be made available to guarantee or secure any indemnification under paragraph (2). The prior approval of SIPC to such indemnification shall be conditioned, among such other standards as SIPC may determine, upon a determination by SIPC that the probable cost of any such indemnification can reasonably be expected not to exceed the cost to SIPC of proceeding under section 9(a) and section 9(b).

Section 9, (§ 9(a)(1) as amended), 92 Stat. 265:

(a) ADVANCES FOR CUSTOMERS' CLAIMS.—In order to provide for prompt payment and satisfaction of net equity claims of customers of the debtor, SIPC shall advance to the trustee such moneys, not to exceed $100,000 for each customer, as may be required to pay or otherwise satisfy claims for the amount by which the net equity of each customer exceeds his ratable share of customer property, except that—

(1) if all or any portion of the net equity claim of a customer in excess of his ratable share of customer property is a claim for cash, as distinct from a claim for securities, the amount advanced to satisfy such claim for cash shall not exceed $40,000 for each such customer;

Section 15, (§§ 16(4), (5) as amended), 92 Stat. 272:

For purposes of this Act, including the application of the Bankruptcy Act to a liquidation proceeding:

(4) CUSTOMER NAME SECURITIES.—The term 'customer name securities' means securities which were held for the account of a customer on the filing date by or on behalf of the debtor and which on the filing date were registered in the name of the customer, or were in the process of being so registered pursuant to instructions from the debtor, but does not include securities registered in the name of the customer which, by endorsement or otherwise, were in negotiable form.

(5) CUSTOMER PROPERTY.—The term 'customer property' means cash and securities (except customer name securities delivered to the customer) at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted. The term 'customer property' includes—

(A) securities held as property of the debtor to the extent that the inability of the debtor to meet its obligations to customers for their net equity claims based on securities of the same class and series of an issuer is attributable to the debtor's noncompliance with the requirements of section 15(c)(3) of the 1934 Act and the rules prescribed under such section;

(B) resources provided through the use or realization of customers' debit cash balances and other customer-related debit items as defined by the Commission by rule;

(C) any cash or securities apportioned to customer property pursuant to section 6(d); and

(D) any other property of the debtor which, upon compliance with applicable laws, rules, and regulations, would have been set aside or held for the benefit of customers, unless the trustee determines that including such property within the meaning of such term would not significantly increase customer property.